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State and Local Governmental Developments— 2002

Complement to AICPA
Audit and Accounting Guides
*Audits of State and Local
Governmental Units*
(Non-GASB 34 Edition) and
*Audits of State and Local
Governments (GASB 34 Edition)*

Notice to Readers

We, as members of the AICPA staff, have developed this Audit Risk Alert to provide you, as an auditor of financial statements of state and local governments, with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits you perform. This document presents brief summaries of recently issued accounting and auditing pronouncements and legal and regulatory provisions. We present those summaries for your information only; you should not rely on them as a substitute for a complete reading of the source material.

This publication is an *Other Auditing Publication* as defined in Statement on Auditing Standards (SAS) No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150). Other Auditing Publications have no authoritative status; however, they may help the auditor understand and apply SASs.

If an auditor applies the auditing guidance included in an Other Auditing Publication, he or she should be satisfied that, in his or her judgment, it is both appropriate and relevant to the circumstances of his or her audit. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

Mary McKnight Foelster
Senior Technical Manager
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Leslye Givarz
Technical Manager
Accounting and Auditing
Publications

We wish to thank Venita M. Wood, an independent consultant in governmental accounting and auditing issues, for her substantial and valuable contribution in developing this Audit Risk Alert. We also wish to thank the various members of the governmental accounting and auditing profession and related disciplines who contributed to this document, including Terri Ahuruonye, William V. Allen, David R. Bean, John Fisher, Eric V. Formberg, Robert J. Freeman, Wesley A. Galloway, Edye Giordano, Benjamin L. Greenberg, L. Michael Howard, Steve Kenneally, Mary Jo Koschay, Elliot P. Lewis, Hugh Monaghan, Jill R. O'Brien, Andrew Parker, Elizabeth Phillips, Kinney Poynter, Terrill W. Ramsey, John E. Reagan III, Roberta Reese, George A. Rippey, Kenneth R. Schermann, Robert G. Taylor, Gilbert Tran, Jon A. Wise, and various staff members of the Internal Revenue Service.

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AICPA

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1 2 3 4 5 6 7 8 9 0 AAG 0 9 8 7 6 5 4 3 2

Table of Contents

STATE AND LOCAL GOVERNMENTAL DEVELOPMENTS—2002	1
Economic and Industry Developments	1
The Effect of September 11 on State and Local Governments	1
The State of the Economy	3
E-Government Applications	6
Electronic Contracts and Signatures	8
Taxation of Internet Sales	8
Regulatory, Legislative, and Other Developments.....	10
Circular A-133 Audit Guidance Update	10
Grants Requirements.....	24
Cash Management Improvement Act Regulations	25
HUD Electronic Submission Requirements for Public Housing Authorities	26
Airport Developments.....	27
Government Auditing Standards	28
Internal Revenue Service Activities	33
Tax-Exempt Financing for Public Schools	43
Securities and Exchange Commission and Municipal Securities Developments	44
Audit and Attestation Issues and Developments	50
Recent Auditing Standards and Other Guidance	50
Proposed Auditing Standards.....	58
Recent Attestation Standards	59
2002 Audit and Accounting Guide and SOP 98-3 Conforming Changes.....	59
Revision of Audit and Accounting Guides for GASB Statement No. 34.....	60
Effect of Adopting GASB Statement No. 34 on Auditors' Reports	72
Ethics Interpretation 101-10	72

Information Systems Security Auditing Guidance	72
Common Engagement Deficiencies.....	73
Governmental Employee Benefit Plan Guidance	74
Accounting Issues and Developments	75
GASB Pronouncements, Exposure Drafts, and Additional Projects.....	75
GASB Statement No. 33 <i>Implementation Issue</i>	84
GASB Statement No. 34 <i>Implementation Guidance</i>	85
FASB Statement No. 145	87
References for Additional Guidance.....	88
AICPA	88
Governmental Accounting Standards Board	94
Federal Agencies—Administrative Regulations	95
General Accounting Office.....	96
Office of Management and Budget.....	98
Other Guidance	99
PCIE Audit Committee Guidance	99
Government Finance Officers Association	100
APPENDIX A—CIRCULAR A-133 AUDIT REFRESHER— MAJOR PROGRAMS	105
APPENDIX B—THE INTERNET—AN AUDITOR’S RESEARCH TOOL....	116

State and Local Governmental Developments—2002

Economic and Industry Developments

The Effect of September 11 on State and Local Governments

The terrorist attacks of September 11, 2001, have had a profound effect on the nation and changed the landscape of daily life in America, perhaps forever. State and local governments have been in the forefront of that change, responding rapidly and decisively in the wake of those attacks to make operational changes in the public interest.

Numerous public safety and emergency response personnel from state and local governments were on the front lines in New York City, Washington, D.C., and rural Pennsylvania to deal with the immediate aftermath of the attacks. Within hours, state and local governments were taking actions to ensure the security of citizens, employees, and buildings. Some governments held fund-raising events to collect contributions to aid persons or organizations directly affected by the attacks. In the days and weeks following the attacks, many government employees volunteered countless hours of time to response efforts.

In the forefront of operational changes for state and local governments have been emergency response plans. Although many governments previously had such plans, the plans were not designed for this new type of terrorism. Some states have created offices of homeland security or commissions to address security and possible terrorism. Local governments have reexamined and retooled their defenses. Governments also have developed or redesigned business continuity plans and reconsidered their insurance coverages, especially coverage for catastrophic losses.

Public health issues came into the spotlight with the bioterrorism threats following the attacks. In addition to offering education and

training activities for emergency providers, governments began considering ways to bolster their public health infrastructure and improve the coordination of federal, state, and local resources. Various jurisdictions increased their mental health services, especially those directed towards children.

The security of the public infrastructure, such as airports, power plants, and water supplies, has received significant attention since September 11. The Nuclear Regulatory Commission placed all nuclear reactors at the highest state of alert following the attacks. That state of alert included increased patrols, additional security forces and security posts, and further coordination with law enforcement and military authorities. Some states “scrubbed” their Internet sites, removing information from Web pages because it might be useful to terrorists in planning attacks. Many governments have increased the security on their Internet sites.

Governments have communicated these post-September 11 actions to a concerned public, both through the conventional press and through postings on their Web sites. All of the actions discussed above have increased expenditures for state and local governments, as described in more detail in the following section of this Alert entitled “The State of the Economy.”

When planning and performing the audit of a government’s financial statements, you should consider the effect of these and other September 11-related actions on its daily business processes, internal control, and financial statements. (See also the discussion of audit risk factors in the later section of this Alert entitled “Recent Auditing Standards and Other Guidance.”) The February 2002 edition of the Governmental Accounting Standards Board’s (GASB’s) monthly newsletter, *Action Report*, discusses the possible reporting of the effects of September 11 events as extraordinary items, which would involve governments that report using proprietary funds as well as those that apply the provisions of GASB Statement No. 34, *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments*. That discussion indicates that, for a small number of governments directly affected by the attacks, some items may qualify for accounting treatment as extraordinary items.

For any financial statements for periods before September 11, 2001, on which you have not yet issued an auditor's report, consider the need for the financial statements to include disclosure about subsequent events relating to the attacks (such as significant increases in public safety and security expenditures. Using the guidance of SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 560, "Subsequent Events") would be helpful in this regard. Generally, the effect of the September 11 attacks will be a type 2 event, providing evidence with respect to conditions that arose after the balance sheet date but of such a nature that it should be disclosed to prevent the financial statements from being misleading. SAS No. 1 (AICPA, *Professional Standards*, vol. 1, AU sec. 530.05, "Dating of the Independent Auditor's Report") describes the two methods available for dating the auditor's report when a subsequent event disclosed in the financial statements occurs after completion of field work but before issuance of the report.

The State of the Economy

The economic downturn that affected the nation throughout 2001 and into 2002, which did not spare state and local governments, stands in stark contrast to the economic boom of the 1990s. In response to recent economic constraints, many governments have been able to avoid major tax increases by cutting spending and dipping into surpluses, rainy-day funds, or other reserves.

Even before September 11, the financial picture for state and local governments had weakened. Stock market prices and interest rates were down, unemployment was increasing, and consumption was slowing. State revenues from taxes were decreasing, especially in manufacturing states. After adjusting for tax law changes and inflation, including sales tax rate increases by a significant number of states, state tax revenues in the fourth quarter of 2001 were down almost 3 percent as compared to the same quarter in 2000. That fall-off in tax revenues was fueled by significant declines in personal and corporate income taxes. In addition, revenues from the 1998 tobacco settlement were (and likely will continue to be) significantly lower than originally projected. Federal aid, especially for Medicaid

costs, was decreasing for many states. By the end of 2001, about 80 percent of the states indicated current or anticipated financial difficulties for fiscal year 2002. Concerning local governments, an October 2001 study of cities showed an expected annual revenue decline of 4 percent. Despite that finding, a recent rating agency report found that local governments have done a good job of managing the economic downturn through sound budget management. Further, higher property tax revenues resulting from rising property values in tax bases have helped to ease the strain of weaker local sales and income taxes. Also, a significant number of local governments raised their sales tax rates in 2001.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (the Act) (Public Law [P.L.] 107-016) became law on June 7, 2001. That \$1.35 trillion federal tax cut bill added to the states' fiscal woes. Although the Act's effect on the various states is disparate and depends on an individual state's tax structure, it has been reported that the Act will cause the states collectively to lose \$65 billion to \$100 billion in revenues in the next five years. Most of that lost revenue will come from the phase-out of the federal estate tax, which will eliminate the estate tax in 40 states and significantly reduce it in the other 10 states over a 4-year period starting in 2002. (Some states, however, are considering legislation to reinstitute a state-level estate tax that is independent of the federal tax rollback.) In addition, a large amount of state revenue will be lost because of the reduction in the federal income tax base. The Act reduces the federal income tax base by expanding items that reduce the amount of income that is taxed, such as increases in deductible contributions to individual retirement accounts (IRAs). Many states base state taxable income on federal adjusted gross income or federal taxable income.

The terrorist attacks accelerated the economic problems for state and local governments by further depressing the nation's economy and consumer confidence. Governments with economies that directly or indirectly depend on conventions, tourism, and travel were affected by the downturn in those sectors. The revenues of governmental airports suffered significantly from airport closures and decreased air travel. Troop deployment has depressed the economies of communi-

ties with large populations of military personnel. The attacks and related events also directly and indirectly introduced new or increased expenditure needs relating to, for example, public safety, emergency management, homeland and building security, welfare, and medical services. Many states have instituted expenditure control measures, such as hiring freezes or appropriations holdbacks, including reduced support to local governments.

Some federal agencies, such as the U.S. Department of Health and Human Services (HHS) and the Federal Emergency Management Agency (FEMA), have redirected existing funding to provide emergency grants to state and local governments. But, despite lobbying by state and local government associations and the introduction of federal legislation, the federal government may not be able to appropriate new monies to help finance the increased expenditure needs of state and local governments in any significant manner given its own troubles with depressed revenues and anti-terrorist spending. (See also the discussion in the later section of this Alert entitled “Airport Developments” concerning federal aid to airports.)

When there might be marked improvement in these economic factors depends, in part, on unknown factors, including the success of anti-terrorism efforts overseas and domestic security efforts. However, there have been glimmers of improvement in the national economy during the first quarter of 2002. How an individual government manages its economic problems depends on the diversification of its economy and its flexibility to adjust revenues (such as through tax increases or the use of tobacco settlement funds) and spending, future commitments (such as for capital improvements), borrowing capacity, and reserve funds.

Given the current uncertain economic times, we want to remind auditors about the guidance in SAS No. 59, *The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341). That standard requires the auditor to evaluate whether there is substantial doubt about the entity’s ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited. SAS No. 59 also provides guidance on (1) the auditor’s evaluation of whether there is substantial

doubt about the entity's ability to continue as a going concern, (2) the adequacy of financial statement disclosure, and (3) the need to modify the auditor's report.¹ Ordinarily, a government's financial statements are prepared based on the assumption that the government will continue as a going concern. SAS No. 59 states that, ordinarily, information that significantly contradicts the going concern assumption relates to the entity's inability to continue to meet its obligations as they become due without substantial disposition of assets outside the ordinary course of business, restructuring of debt, externally forced revisions of its operations, or similar actions.

Some hold the position that many governments are not subject to the factors that might threaten the future existence of a business enterprise because governments have the power to assess and levy taxes (and other charges) sufficient to finance operations and to service long- and short-term debt. However, some governments have constitutional or statutory limits on their taxing powers. Further, the ability to generate revenues, even if unlimited by law, can be limited by the incomes and resources of taxpayers. Therefore, as required by SAS No. 59, you should evaluate the government's ability to continue as a going concern. (See also the discussions about municipal securities disclosures about fiscal stress and audit risk factors in the later sections of this Alert entitled "Securities and Exchange Commission and Municipal Securities Developments" and "Recent Auditing Standards and Other Guidance.")

E-Government Applications

State and local governments are increasing their presence on the Internet through electronic government (e-government) applications. E-government is the process of using the Internet to provide information and services to citizens and to otherwise conduct the business of government. At the simplest level, e-government applications can be achieved by using a Web site as a bulletin board or database—

1. Statement on Auditing Standards (SAS) No. 96, *Audit Documentation*, amends SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341.17), by requiring audit documentation concerning the auditor's going concern evaluation. See the later section of this Alert titled "Recent Auditing Standards and Other Guidance.")

“publishing” annual financial statements, posting school closing data, and permitting access to real estate and court records. Other governmental Web sites may provide interactive or transactional applications, for example, to send e-mails to government officials, file tax returns and pay taxes, apply for vehicle registrations and driver’s licenses, hold auctions of delinquent tax properties, take bids on competitive sales of municipal securities and purchases of investments, register deeds and mortgages, and vote.

Each of the 50 states has a Web site, and it has been reported that more than 80 percent of local governments have one. A recent study shows high usage of government Web sites: 50 percent of adult Internet users visited a state or local government Web site in the past year. Another study shows that Americans feel that e-government will not only change the way they relate to government as customers of government services, but also as citizens of a democracy by improving citizen participation and government accountability.

Stay abreast of the e-government initiatives that the governments you audit undertake. In performing analytical procedures, you may see increased information technology (IT) costs. Conversely, some governments are cutting back on planned IT initiatives given current economic conditions. Further, the collection of certain information and payments over the Internet will introduce IT applications and may introduce the use of service organizations to consider in your evaluation of the entity’s internal control over financial reporting. Make sure you are aware of the provisions of SAS No. 70, *Service Organizations*, as amended (AICPA, *Professional Standards*, vol. 1, AU sec. 324), and SAS No. 94, *The Effect of Information Technology on the Auditor’s Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), which amended and expanded the discussion in SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*. (See also the later section of this Alert entitled “Information Systems Security Auditing Guidance” as well as the later section entitled “Recent Auditing Standards and Other Guidance,” which discusses AICPA Auditing Interpretations and an AICPA Audit Guide on SAS No. 70, as amended.)

Help Desk—The National Electronic Commerce Coordinating Council (NECCC) is an alliance of state government organiza-

tions dedicated to the advancement of electronic commerce within states. At its Web site at www.ec3.org, NECCC has a number of white papers addressing e-government issues. One paper, *Critical Business Issues in the Transformation to Electronic Government*, describes the critical business issues and best practices that decision-makers, managers, and auditors should be aware of as governments transform themselves into e-governments. Another paper, *Risk Assessment Guidebook for e-Commerce/e-Government*, is intended to help auditors identify emerging e-government applications, identify the key risks associated with these applications, and assess the effect of that risk on their audit work.

Electronic Contracts and Signatures

In last year's Alert, we discussed how the federal government and various state governments had been enacting legislation to remove barriers to e-commerce by addressing the legality of electronic contracts and signatures. Effective January 1, 2002, NACHA, The Electronic Payments Association permits the use of electronic signatures for Automated Clearinghouse (ACH) debits. The ACH network is commonly used for direct deposit of payroll and government benefits, direct payment of consumer bills, business-to-business payments, federal tax payments, and e-commerce payments. Under the new rule, any electronic signature that complies with the Electronic Signatures in Global and National Commerce Act (P.L. 106-229) will comply with NACHA's requirements.

Taxation of Internet Sales

For the past few years, we have alerted you to the continuing debate over the taxation of Internet sales. The District of Columbia, 45 states, and thousands of local governments impose sales taxes. State and local governments are concerned about losing sales tax revenues because of untaxed Internet sales. A recent study of tax revenue lost because of the nontaxation of Internet sales puts the amount at \$440 billion over the next 10 years. Internet businesses claim that disparities in sales tax systems among the various jurisdictions make it too burdensome to administer collection of sales taxes.

When we left the issue of the taxation of Internet sales in last year's Alert, Congress had been unable to pass Internet taxation legislation because of serious differences of opinion about whether and under what conditions state and local governments should be able to impose sales taxes on Internet sales. A ban on new Internet access taxes and new, multiple, and discriminatory taxes on electronic commerce, first legislated in 1998, expired in October 2001 and was reinstated through November 1, 2003, by the Internet Nondiscrimination Act (P.L. 107-075). The law did not address any issues relating to conditions for eventual Internet taxation, which was addressed in a report to Congress in 2000 that recommended it take steps to simplify state and local sales taxes.

Over 30 states are attempting to simplify and modernize sales tax collection and administration through the efforts of the Streamlined Sales Tax Project, which is developing the Streamlined Sales Tax System (SSTS). The SSTS would provide incentives for out-of-state vendors to collect sales taxes when they are not otherwise required to do so, including:

- Uniform definitions of taxable products and services
- Liability relief to sellers for inappropriate claims of tax exemption by buyers
- A single tax rate per jurisdiction
- State responsibility for distributing taxes to local governments
- Uniform rules for determining the state that is the source of a sale
- Limited tax audits on sellers
- State financing of the system

Almost 30 states have enacted or are considering legislation that would permit them to participate in the SSTS. Participation in the SSTS by vendors also would be voluntary.

Help Desk—Additional information about the Streamlined Sales Tax Project is available on the Internet at www.streamlinedsalestax.org.

Regulatory, Legislative, and Other Developments

Circular A-133 Audit Guidance Update

2002 Compliance Supplement Issued

The Office of Management and Budget (OMB) Circular A-133 *Compliance Supplement* (the Supplement) is based on the requirements of the Single Audit Act Amendments of 1996 (the Act) and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (Circular A-133). Those requirements provide for the issuance of a compliance supplement to assist auditors in planning and performing the required audits. The Supplement identifies existing compliance requirements that the federal government expects to be considered as part of an audit in accordance with the Act and Circular A-133, and use of the Supplement is mandatory.

The OMB issued its 2002 Supplement in March. The 2002 Supplement includes information to help you understand the objectives, procedures, and compliance requirements of 159 federal programs. Part 7 of the Supplement, “Guidance for Auditing Programs Not Included in This Compliance Supplement,” provides guidance to help you determine relevant compliance requirements, audit objectives, and suggested audit procedures for programs not included in the Supplement. Although the primary focus of the work on the 2002 Supplement was to update previously included federal programs, it does add eight programs, three of which result in a new program cluster and one of which is a combination of two previously included programs. The 2002 Supplement is effective for audits of fiscal years beginning after June 30, 2001.

Appendix V of the Supplement lists changes from the 2001 Supplement. Among the more significant changes, the 2002 Supplement:

- Revises three compliance requirements in Part 3, “Compliance Requirements.” In “Allowable Costs/Cost Principles,” additional information is provided on cost allocation plans and indirect cost rates. In “Special Tests and Provisions,” the requirements relating to Year 2000 considerations are deleted. In “Davis-Bacon Act,” the requirement to test contractor and

subcontractor payrolls is replaced with the requirement to determine whether the nonfederal entity notified contractors and subcontractors of the requirements to comply with the Davis-Bacon Act and obtained copies of certified payrolls. (A similar change for the Davis-Bacon Act is made in Part 6, “Internal Control.”)

- Revises, in Part 4, “Agency Program Requirements,” and Part 5, “Clusters of Programs,” the program requirements for many existing programs and program clusters for the effect of new laws and regulations or for other reasons.

Help Desk—You may purchase the 2002 Supplement from the Government Printing Office or download a free electronic copy from the OMB Web site as discussed in the section entitled “References for Additional Guidance” at the end of this Alert. Further, the Catalog of Federal Domestic Assistance (CFDA) numbers for federal programs often change. You can obtain information about number changes in the CFDA’s list of current year changes and in its Appendix VII, “Historical Profile of Catalog Programs,” which lists changes since 1965. The table of contents for the CFDA, which can take you to all sections of the CFDA, is on the Internet at www.cfda.gov/public/cat-whatshere.htm.

Data Collection Form Revision and Electronic Submissions

The Federal Audit Clearinghouse (FAC) collects information about Circular A-133 audits on a data collection form for entry into a database that is accessible through its Web site. Last year, the OMB issued a revised form and accompanying instructions to report the results of Circular A-133 audits for fiscal periods ending on or after January 1, 2001. Audits covering fiscal period end dates before January 1, 2001, should continue to use the previous version of the data collection form dated August 1997.

Help Desk—You can complete and submit the new and previous data collection forms electronically at the FAC Web site at harvester.census.gov/sac, as discussed later in this section. The data collection forms and related instructions also are available in portable document format (PDF) versions at the FAC Web site. You can obtain printed copies from the FAC by calling (888) 222-

9907. When ordering printed copies by phone, note that the form number is SF-SAC and that you will need to indicate whether you need the new or previous form. You and the governments you audit are not permitted to create your own version of the forms.

Questions About Data Collection Form. Auditors and auditees have adapted well to the change in the data collection form. However, the following information describes a few items in the form that have prompted questions:

- *Multiple Employer Identification Numbers (EINs) (part I, items 5(b) and (c)).* The form requires the auditee to complete an additional page (page 4) to provide the multiple EINs, if any, covered in the report. For example, some departments or component units of state governments may have been assigned a separate EIN by the Internal Revenue Service (IRS). Only a small percentage of filers have multiple EINs. The FAC needs information about all EINs covered by the filing to properly identify which organizations are intending to satisfy their Circular A-133 audit requirement with the filing.
- *Other Entities (part III, item 2).* This question asks if the auditor's report includes a statement that the auditee's financial statements include departments, agencies, or other entities that had a separate Circular A-133 audit that is not included in the auditee's Circular A-133 audit. (AICPA Statement of Position [SOP] 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, paragraph 10.54, states that if the audit of federal awards did not encompass the entirety of the auditee's operations expending federal awards, the operations that are not included should be identified in a separate paragraph in the auditor's report.) The form's instructions clarify that an auditee should not submit a reporting package or data collection form if the entity's operations are included in another entity's Circular A-133 audit report. For example, a university that is included in a state's Circular A-133 audit report and data collection form should not submit a separate reporting package or data collection form.

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- *Audit Findings (part III, item 8).* This item asks whether a summary schedule of prior audit findings was prepared. The intent of this item is to determine whether the auditee complied with the provisions of section 315 of Circular A-133. That section requires, in part, that the auditee prepare a summary schedule to report the status of all audit findings included in the prior audit's schedule of findings and questioned costs relative to federal awards as well as all audit findings reported in the prior audit's summary schedule of prior audit findings. However, findings in the prior audit's summary schedule of prior audit findings listed as corrected, no longer valid, or not warranting further action as provided in Circular A-133 need not be included in the current summary schedule of prior audit findings. Some auditees do not have prior audit findings to report but, nevertheless, prepare a summary schedule of prior audit findings stating that there were no such findings. In that situation, the auditor should answer "no" to part III, item 8, because, even though a summary schedule of prior audit findings was prepared, it only states that there were no prior audit findings to report.

Auditors are reminded to exercise care in identifying whether or not individual federal awards were received directly from a federal awarding agency, which is a required data field on the data collection form (part III, item 10e). When an award consists of both direct and indirect (received by a subrecipient through a pass-through entity) funds, the auditor should list direct expenditure detail on one line and indirect expenditure detail on another line. The correct classification of awards as direct or indirect is important for identifying cognizant and oversight agencies for audit and for the federal agencies to track awards. FAC has observed a number of data collection forms for local school districts listing Title I Grants to Local Educational Agencies (CFDA number 84.010) as direct awards when, in fact, Title I grants are made to states and always are indirect awards to local school districts.

Online Form Submissions. As we reported in the Alert for the past two years, the FAC now permits online submissions of the data

collection form on its Web site in a system called the Internet Data Entry System (IDES). The FAC has received about 60 percent of fiscal year 2001 data collection forms through the IDES. The OMB and the FAC encourage auditors and auditees to increase their use of the IDES to submit data collection forms.

The IDES makes completing the data collection form quicker, easier, and more accurate. The IDES allows you and your auditees to complete your portions of the data collection form online directly into the system, and to benefit from online edits on the data entered in many items before submitting the form. In fact, the IDES does not permit the form to be submitted online if there are unresolved edit failures. Although the form is submitted electronically through this process, it still needs to be printed, signed, and dated by you and the auditee, and mailed to the FAC with the appropriate number of audit reporting packages.

Errors Noted in IDES Submissions. Reports on 2001 audits filed using the IDES have experienced a rejection rate of about 13 percent, as compared to a rejection rate of about 30 percent in non-IDES submissions. The following are among the reasons for the FAC's rejection of IDES submissions:

- Lack of familiarity with the new form
- Failure to include all the parts of the reporting package with the data collection form
- Not signing or dating the form
- Listing multiple CFDA programs on one line
- Entering a program name as "none"

The FAC also has been rejecting IDES submissions because auditors or auditees use correction fluid to make changes to the paper copy of the data collection form after electronic submission. This often occurs because the form is submitted through the IDES before the auditor and auditee complete their reviews and identify changes that are needed to the data on the form. For review purposes, auditors and auditees should print the form in draft mode, not in the final mode that is available after the form is submitted.

Data collection forms submitted through the IDES are locked when the “submit” button is pushed. If after submitting a form you later determine that data in it needs to be changed, and the paper copy has not yet been mailed to the FAC with the reporting packages, you can call the FAC and ask them to unlock the form to permit the change. (The FAC is looking into how to enhance the IDES to allow revisions of online submissions without having the FAC unlock the form.) However, if the paper copy has been mailed, you will need to submit a revised data collection form in hard copy format to make the change.

Finally, the FAC has been rejecting IDES submissions because paper copies of the form show different report identification numbers on different pages and are printed in draft form or are printed by using “print screen,” which cuts off part of the fields. When an auditor or auditee “creates a session” by beginning the process of inputting data into a form for a particular auditee and audit year, the IDES assigns a report identification number. The auditor and auditee can log off the system and later reenter the session using the report identification number and a password that the auditor or auditee created when the session began. Sometimes the auditor or auditee loses the password and creates a new session for the same form, completing only the pages that were not filled in and printed during the previous unsubmitted session. When a form is printed in draft or print screen modes and created in different sessions under different identification numbers, the form is never subjected to the IDES edits and never submitted to the FAC database. Therefore, while on paper it might appear to the auditor and auditee that they have submitted the form through the IDES, that is not the case. Instead, the unedited data remains in different files on the Internet and never makes its way through the FAC firewalls into the IDES. When submitting a form through the IDES, you should be sure to work in a single session (thereby creating a single file and report identification number) and follow the submit and print instructions. Also be sure to document the password for the session because the FAC cannot retrieve passwords.

One feature of the IDES that has greatly reduced error rates and effort is the ability to upload (rather than manually input) a large num-

ber of programs or contracts in the form's listing of federal awards expended (page 3) and a large number of EINs (page 4) from spreadsheet files. Instructions for uploading spreadsheet files are on the FAC Web site. This upload feature, which reduces data entry effort, makes the use of the IDES especially beneficial for auditors of large entities and entities with a large number of federal awards.

Help Desk—If you have questions or encounter problems while entering data on the IDES, you can call the FAC for customer assistance at (800) 253-0696, from 7A.M. through 5:30 P.M. Eastern time. Customer assistance can help you with your issue while you are online with the IDES. You also can e-mail your question or problem to the FAC at govs.fac@census.gov if you do not need assistance while online.

Federal Grant Streamlining Program

The Federal Grant Streamlining Program (FGSP) is the result of the Federal Financial Assistance Management Improvement Act of 1999 (P.L. 106-107) (the Act), which requires each federal agency to develop and implement a plan to streamline and simplify the application, administrative, and reporting procedures for federal financial assistance programs. In May 2001, 26 federal grant-making agencies submitted to Congress and to the Director of OMB an initial plan to implement the Act by setting forth goals, objectives, approach, status, and accomplishments. Due to various organizational issues, progress on many of the plan's deliverables has been delayed, but progress continues nevertheless. Recent and upcoming efforts of the FGSP include the following:

- Published two plain-English documents about Circular A-133 audits. (See the discussion later in this section.)
- Worked with various federal agencies to publish a notice of proposed rulemaking to change and amend the government-wide nonprocurement common rule for debarment and suspension and the government-wide rule implementing the Drug-Free Workplace Act of 1988. (See the later section of this Alert entitled "Grants Requirements.")
- Reviewed FAC operations, finding that in general the FAC was operating well and meeting user needs, but further in-

vestigation to improve the reports generated by the database is ongoing.

- Developed a common format and template for all federal grant announcements, which is being reviewed by the federal agencies and may be instituted sometime in 2002.
- Developing a methodology to identify nonfederal entities that expend more than \$300,000 in federal financial assistance annually but that have not submitted Circular A-133 audit reports. The FGSP is reviewing federal payment systems to identify those entities.
- Reviewed OMB Circulars A-21, *Cost Principles for Educational Institutions*, A-87, *Cost Principles for State, Local, and Indian Tribal Governments*, and A-122, *Cost Principles for Non-Profit Organizations*, to identify and resolve conflicting or confusing definitions of allowable cost items appearing in all three circulars that have a consistent policy basis. The OMB is expected to issue a notice of proposed rule-making in the *Federal Register* on this effort in 2002.
- Surveying federal quality control review (QCR) activity and processes. The FGSP is finalizing its reviews of (1) whether and how QCRs are conducted and whether they give reliable information and (2) grantor agency expectations of the Circular A-133 audit process. The results of those reviews will be presented to the President's Council on Integrity and Efficiency (PCIE) and the federal government's Chief Financial Officer's Council (CFOC). (See also the discussion of the results of certain Circular A-133 audit reviews later in this section.)
- Recommended that OMB not propose revising OMB Circular A-110, *Uniform Administrative Requirements for Grants and Agreements With Institutions of Higher Education, Hospitals, and Other Non-Profit Organizations*, to require that federal agencies offer grantees the option to request cash advances on a pooled basis. The OMB is expected to issue a notice in the *Federal Register* in 2002 concerning this position.

OMB is asking each federal grant-making agency to submit an annual report to OMB and the Congress on its progress in implementing the plan for grant streamlining and its performance in meeting the goals and objectives of the Act. The target due date for those reports is June 30, 2002.

Plain-English Circular A-133 Audit Publications

The CFOC published two documents, *Highlights of the Single Audit Process* and *Single Audit Basics and Where to Get Help*, which have been sent to all recipients listed in the FAC database. Those documents provide recipients and grantor agency personnel with plain-English descriptions of the Circular A-133 audit process and information about where to find help obtaining or understanding the requirements. Some of the entities you audit may receive those documents and ask you about them. You also could provide the documents to auditees that become subject to Circular A-133 audit requirements for the first time to help them understand the process. Both documents are subject to revision and, for that purpose, the CFOC is soliciting suggestions for improvement.

Help Desk—The documents are posted on the CFOC’s Web site at www.cfoc.gov/documents/pdf_gmc_pamphlet.pdf and www.cfoc.gov/documents/pdf_gmc_cfoBrochure.pdf. Any suggestions you have for improving the documents should be sent by e-mail to PL106107@os.dhhs.gov.

Orange Book

The PCIE hopes to soon issue a revision of *Federal Cognizant Agency Audit Organization Guidelines*, also known as the “Orange Book.” The Orange Book, originally issued in 1985, sets forth the responsibilities of the cognizant agencies for audit, addressing areas such as technical advice and liaison, desk reviews of audit reports, reviews of audit organizations and their work, resolution of deficiencies noted during reviews, and processing audit reports. The revision will consider, among other things, the effects of the Single Audit Act Amendments of 1996 and Circular A-133. The revision also is expected to provide guidance to oversight agencies for audit as well as to the cognizant agencies.

Help Desk—When issued, the Orange Book should be available on IGnet, the Inspectors General’s Web site, at www.ignet.gov. Consider reviewing the Orange Book to gain an understanding of the processes used by the Inspectors General and how they could affect your engagements.

Circular A-133 Audit Reviews

To obtain more information about the Circular A-133 audits of the grants they administer, many federal Offices of Inspectors General (OIGs) and state-level agencies with oversight responsibilities for Circular A-133 audits are increasing their scrutiny of completed audits through desk reviews, QCRs, and other types of examinations. In last year’s Alert, we discussed some of the problem areas identified by the OIGs. Since then, the OIGs have performed additional reviews and are continuing to report similar problems. Notable among the problems identified by the OIGs are sample sizes that appear too small, a lack of required documentation, a failure to perform (or perhaps to document) required internal control and compliance work, and failure to appropriately apply the risk-based approach to determining major programs. (See the refresher on selecting major programs for Circular A-133 audits in Appendix A.) As a result, the number of referrals by the OIGs to the AICPA Professional Ethics Executive Committee (PEEC) for substandard Circular A-133 audits has been rising. The following paragraphs summarize some of the findings that certain federal agency OIGs have found in their reviews. You should review these summaries to help ensure that you avoid some of the common pitfalls noted.

Help Desk—Among the tools that the OIGs use to perform desk reviews and QCRs are two checklists from the PCIE—the *Uniform Guide for Initial Review of A-133 Audit Reports* and the *Uniform Quality Control Review Guide for A-133 Audits*. Copies of those guides are available on the Internet at www.ignet.gov/pande/audit/psingle.html. Before completing your Circular A-133 audits, consider reviewing the guides to gain an understanding of what the OIGs will be looking for in their reviews. Taking this step will help ensure that your engagements meet the criteria identified.

Department of Health and Human Services. The HHS OIG not only has identified various quality issues through desk reviews and QCRs, but also has used the FAC database to identify possible errors in Circular A-133 audits for audit quality follow-up and possible referral for substandard work. The major problem noted in these reviews has been a failure by auditors to appropriately apply the risk-based approach for determining major programs. Circular A-133 requires a type A program to be audited as a major program unless it qualifies as a low-risk program. Section 520(c) of the Circular states that for a type A program to be considered low-risk, it must, among other criteria, have been audited as a major program in at least one of the two most recent audit periods. A significant number of type A programs that did not qualify as low-risk programs in 2000 because they had not been audited as major in 1998 or 1999 were not audited as major programs in 2000.

HHS OIG has indicated that ensuring the quality of Circular A-133 audits will continue to be a focus area. It will concentrate most of its efforts in the upcoming year on audits of states and local governments, as well as colleges and universities. In addition to reviewing Circular A-133 audit work, the OIG also will be examining other areas. For example, the office will be looking closely at the cash management practices of colleges and universities. In addition, the OIG will be looking closely at the Medicare and Medicaid grant programs and the Ryan White HIV/AIDS program Title I and Title II grant funds at the state and local level.

Department of Labor. In its QCRs, the U.S. Department of Labor (DOL) OIG also has noted some problems related to two specific DOL programs: the Dislocated Worker (DW) program (CFDA number 17.255) and the Job Training Partnership Act (JTPA) program (CFDA number 17.250). (Although the JTPA program has been replaced with various Workforce Investment Act [WIA] programs, the issue of cash management compliance discussed in this paragraph is equally applicable to the WIA programs.) The OIG found eligibility problems with the DW program. For example, the eligibility was not adequately documented for over one-third of the individuals served by the program—participants were ineligible, documentation was insufficient to establish participant eligibility,

or available evidence made the OIG question whether participants were persons whom the program intended to serve. The OIG found cash management problems with the JTPA program that involved a considerable time lag between the receipt of program funds and payments to vendors. If you audit either of these programs, you should consider the general guidance in Part 3 and the specific program guidance in Parts 4 and 5 of the *Compliance Supplement* when testing both eligibility and cash management.

The DOL OIG also has noted problems concerning (1) the sufficiency of compliance testing and (2) documentation. Design problems with audit tests have resulted in certain federal funds being excluded from the test population. Certain compliance requirements that were applicable in the circumstances either were not tested for internal control or had sample sizes that were inadequate to test internal control for a low assessed level of risk as required by OMB Circular A-133. In most cases, auditors did not document sampling assumptions or methodologies. Auditors did not perform additional procedures to gather sufficient evidence to support the opinion on compliance, even when the audit work performed revealed errors indicating a high-risk system and a high probability of material noncompliance.

Certain other compliance requirements that were applicable in the circumstances received no control or substantive testing, and the auditors failed to document why these tests were not performed. Most notable was the lack of eligibility testing for DOL's training grant programs. Those programs typically have centralized local intake and eligibility systems. If you are testing one of those programs in that situation, you should ensure that eligibility is tested in conjunction with the recipient or subrecipient entity you are auditing, or tested centrally.

Help Desk—The complete report of the DOL OIG reviews is available from its Web site at www.oig.dol.gov/public/reports/oa/main.htm.

Circular A-133 audits are a primary mechanism for the DOL OIG to obtain assurance that recipients and subrecipients maintain effective internal control over federal awards and report reliable

financial information on the use of such awards. Grantees and their auditors should be aware that DOL intends to increase its monitoring and evaluation activities of recipients and subrecipients to obtain additional information about DOL programs for purposes of the audit of DOL's consolidated financial statements.

Department of Transportation. During the last year, the U.S. Department of Transportation (DOT) OIG performed a targeted review of the Circular A-133 audit work being performed on the Airport Improvement Program (AIP) related to revenue diversion (which is included as a special test and provision compliance requirement in the *Compliance Supplement* for the AIP [CFDA number 20.106]). The basic requirement for use of airport revenues is that all revenues generated by a public airport must be expended for the capital or operating costs of the airport, the local airport system, or other local facilities that are owned or operated by the owner of the airport and that are directly and substantially related to the air transportation of passengers or property.

The OIG examined the Circular A-133 audit documentation related to revenue diversion in the audits of 11 airports around the country. The primary deficiencies consistently found in each of the audits examined included transaction testing that did not include airport revenue expenditures; payments to the sponsor or other government entities that were not tested; and indirect charges from the sponsor to the airport that were not reviewed. If you audit an airport, you should pay special attention to the guidance in the *Compliance Supplement* related to this program, specifically in the area of revenue diversion. You should be aware that airport revenue expenditures are not the same as grant expenditures and ensure that your airport expenditure review considers high-risk areas for diversion, such as payments to airport sponsors and other governmental entities. Further, you should become familiar with the underlying DOT regulations related to revenue diversion, which are referred to in the *Compliance Supplement* under the AIP.

Help Desk—Policies and Procedures Concerning the Use of Airport Revenue, in the February 16, 1999, *Federal Register* (64 FR 7695), contains the definitions of airport revenue and unlawful

revenue diversion, provides examples of airport revenue, and describes permitted and prohibited uses of airport revenue. The policy can be obtained from the Federal Aviation Administration (FAA) Web site at www.faa.gov/arp/fedreg.htm.

Department of Education. The U.S. Department of Education (ED) OIG also has performed its share of QCRs during the past year. The most common problem found by the OIG in its reviews is that there is not proper audit documentation for the audit work. You should look at both SAS No. 96, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), and the field work standards in *Government Auditing Standards*, which include additional audit documentation requirements. (See the discussion of SAS No. 96 in the later section of this Alert entitled “Recent Auditing Standards and Other Guidance.”) Other deficiencies noted by the OIG include audit documentation that refers to working papers that do not exist or that do not include the referenced work; lack of internal control testing as required under Circular A-133 (in some cases there was no detailed testing and in others only some aspects of controls were tested); problems with the application of the risk-based approach to determining major programs; discrepancies in the information contained in the data collection form; and failure to obtain all required management representations.

The ED OIG also has noted that some institutions of higher education are not including certain loan and loan guarantee programs (for example the Federal Family Education Loan Program [FFELP] and the Direct Loan Program) in their schedules of expenditures of federal awards. Section 208(c) of Circular A-133 requires that when loans are made to students but the institution of higher education does not make the loans, the value of the loans made during the year is considered federal awards expended. Section 310(b)(6) of Circular A-133 requires those loans and loan guarantees to be reported either on the face of the schedule or disclosed in the notes to the schedule. If you are auditing an institution of higher education, you should be sure that you are considering these loans and loan guarantees as you go through the process of determining major programs.

Department of Housing and Urban Development. The U.S. Department of Housing and Urban Development (HUD) Real Estate Assessment Center (REAC) has performed a number of quality reviews on Circular A-133 audit work performed on public housing authorities (PHAs), focusing its efforts on the firms that audit more than half of the HUD funds expended by PHAs. In its reviews, HUD REAC found problems consistent with the issues raised by the other federal agencies discussed above. HUD REAC has stated that it is in the process of preparing referrals to both the AICPA PEEC and State Boards of Accountancy for certain of the egregious cases and will continue to do so for future situations it encounters.

Grants Requirements

Common Rule

In the January 23, 2002, *Federal Register* (67 FR 3265), 28 federal agencies published a notice of proposed rulemaking to make substantive changes and amendments to the government-wide non-procurement common rule for debarment and suspension and the government-wide rule implementing the Drug-Free Workplace Act of 1988. Among the proposals, the rules would (1) allow a federal agency under certain conditions to add agency-specific language to the proposed common rule to prohibit lower-tier procurement transactions with excluded persons, (2) definitively set the dollar threshold on prohibited lower-tier procurement transactions with excluded persons at \$25,000, and (3) permit alternatives to the requirements to obtain written certifications about debarment, suspension, and drug-free workplace from awardees or persons with whom they propose to enter into covered transactions. However, until final regulations are issued and become effective, the current rule's requirements apply.

Circular A-110

The U.S. Department of Commerce (DoC) issued final regulations in the October 1, 2001, *Federal Register* (66 FR 49827) to implement Circular A-110. The new regulations became effective October 1, 2001, and are codified at 15 *Code of Federal Regulations* (CFR) Part 14. Except for provisions relating to the transfer of fed-

eral funds among various cost categories, the final rules are nearly identical to the interim rules issued by DoC in 1998.

Under the interim rules, DoC required prior approval on any re-budgeting request that exceeded 10 percent of the total program costs. The final rules require prior approval for rebudgeting only for awards in which the federal share of the project exceeds \$100,000 and the cumulative amount of such transfers exceeds or is expected to exceed 10 percent of the total program costs. The final rule clarifies that the 10 percent threshold refers to the total federal and nonfederal funds authorized by the grants officer at the time of the transfer request.

Circular A-102

In the November 15, 2000, *Federal Register* (65 FR 68969), HHS issued proposed regulations to apply the Circular A-102 common rule to its entitlement programs. The HHS entitlement programs are listed in the proposed regulations and include, for example, the Aid to Needy Families with Dependent Children, Child Support Enforcement and Establishment of Paternity, and Medical Assistance (Medicaid) programs. HHS hopes to issue final regulations this fall, which will indicate an effective date for those rules.

Cash Management Improvement Act Regulations

If you audit a state government, you should be alert to potential upcoming changes in its Treasury-State Agreement (TSA) under the Cash Management Improvement Act of 1990 (CMIA). In the May 10, 2002, *Federal Register* (67 FR 31879), the Treasury Department's Financial Management Service (FMS) published revised CMIA regulations. The CMIA regulations govern the transfer of funds between the federal government and the states for certain federal assistance programs and require an interest charge when one of the parties fails to make the transfer in a timely manner. (States and their subrecipients also are required by OMB grant administration circulars to minimize the time between transfers.) Compliance with TSAs under the CMIA is one of the audit objectives the Supplement lists for the cash management type of compliance requirement.

The revised regulations raise the default dollar thresholds that determine the programs subject to the interest provisions of CMIA, thereby decreasing the number of programs covered. However, the regulations prevent more than 10 percent of a state's federal assistance programs from being exempted from interest calculations by the threshold change and permit a state to choose to retain a lower threshold to cover more programs. The regulations also make a TSA effective for an agreed-upon term or until terminated (rather than for one to five years), provide for a uniform format for the agreements, and provide a proportional draw requirement only on programs that require mandatory matching of state funds. Unlike the earlier proposed rule, the regulations do not subject cost disallowances to the CMIA's interest provisions. The regulations are effective on June 24, 2002.

Help Desk—The FMS has provided information about the CMIA revision, including frequently asked questions and answers and the revised regulations, at www.fms.treas.gov/cmia/policycmia/faqfinal.html.

HUD Electronic Submission Requirements for Public Housing Authorities

In last year's Alert, we described HUD REAC's requirements for PHAs to submit financial information electronically to HUD's Financial Assessment Subsystem via a template known as a Financial Data Schedule (FDS). We also described the required attestation by auditors on the FDS. The electronic submission process for PHAs has largely remained unchanged during the past year, with one exception. In May 2002, HUD altered the electronic submission requirements for PHAs that are component units of a state or local government. The specific submission requirements will depend on whether the PHA component unit has had a separate audit. If you audit a PHA that is a component unit and are involved in the electronic submission process, you should refer to the updated *Guidelines on Reporting and Attestation Requirements of Uniform Financial Reporting Standards—May 2002* (the Guidelines). It can be found on the HUD REAC Web site at www.hud.gov/offices/reac/

pdf/sas_29_final.pdf and includes specific electronic submission requirements, as well as instructions for the auditor's involvement in the process. A table in Part C of the PHA section of the Guidelines reflects the majority of component unit situations and the related FDS submission requirements.

Airport Developments

Due to the September 11 terrorist attacks, airports have been required to dramatically increase security measures. Acting to preserve the continued viability and security of the U.S. air transportation system, Congress enacted the Aviation and Transportation Security Act (P.L. 107-71) (the Act) in November 2001. Section 121(a) of the Act authorized a total of \$1.5 billion to be appropriated to the Secretary of Transportation for fiscal years 2002 and 2003 to reimburse airports and other organizations similarly affected by the attacks (such as on-airport parking lots and vendors of on-airfield direct services to air carriers) for direct costs incurred to comply with new, additional, or revised security requirements imposed by the FAA or the Transportation Security Administration (TSA).

In the December 21, 2001, *Federal Register* (66 FR 66237), the FAA issued a proposed rule to implement the Act. The proposed rule contains procedures for airport operators, on-airport parking lots, and vendors of on-airfield services to air carriers to file claims for reimbursement under section 121 of the Act of eligible costs incurred to comply with security mandates. Under the proposed rule, all eligible entities would be required to submit an application by June 1, 2002, which would reflect eligible costs incurred from September 11, 2001, through March 30, 2002. (Note that Appendix A to the proposed rule includes a form that the entity must complete.) In addition, the proposed rule contains the following audit requirements related to airports:

- Airport operators that are nonfederal local governments or nonprofit organizations are required to follow the audit requirements of Circular A-133, and requests for reimbursement are to be treated as though the amount had been a federal award.

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- There is no independent audit requirement for applicant requests under \$300,000.

However, the proposed rule also includes the following: “The auditor is not responsible for expressing an opinion on whether a particular claimed cost was incurred to comply with an eligible security requirement. That determination will be made by the FAA or the TSA based on the information submitted with the application as set forth in §154.17. Information identified in §154.17(b) is security sensitive information (SSI) and may be disclosed to auditors only on a need to know basis, in accordance with part 191 of this chapter. Each auditor is considered to be employed by, contracted to, or acting for an airport operator or air carrier, and is responsible for restricting disclosure of SSI in accordance with §191.5 of this chapter.”

In commenting on the proposed rule, the AICPA pointed out to the FAA the apparent inconsistency of asking that the reimbursement request be treated as part of the Circular A-133 audit and the requirement that the auditor is not to opine on whether a claimed cost was incurred to comply with an eligible security requirement. In its letter, the AICPA also offered to explore alternative audit approaches with the FAA. As funds have not yet actually been appropriated for these reimbursements, the FAA does not expect to issue a final rule in the near term. To date, the FAA has not settled on an audit approach that would address some of the concerns expressed by the AICPA.

Government Auditing Standards

The GAO’s 1994 *Government Auditing Standards*, as amended (also known as the “Yellow Book”), is the set of standards you should follow when so required by law, regulation, agreement, contract, or policy for the audits of various entities, including state and local governments. The Yellow Book standards are an integral part of the requirements for a Circular A-133 audit.

Help Desk—The Yellow Book documents discussed in this section are available on GAO’s Web site at www.gao.gov/govaud/ybk01.htm.

Independence Requirements

In January 2002, the GAO made significant changes to the Yellow Book's auditor independence requirements. Amendment No. 3, *Independence*, applies to all Yellow Book audits for financial statements for periods beginning on or after October 1, 2002. GAO encourages early implementation of the provisions of the amendment.

Amendment No. 3 establishes independence standards for CPAs, non-CPAs, government auditors, and performance auditors. It deals with a range of auditor independence issues, including restrictions on nonaudit services. It affects a significant number of audits, applying to auditors of federal, state, and local governments as well as not-for-profit and for-profit recipients of federal (and some state) grants and loans.

Topics Addressed. Amendment No. 3 addresses when auditors and their organizations are independent from the organizations they audit by defining when personal, external, and organizational impairments to independence exist. The amendment applies not only to auditors but also to specialists—such as actuaries, appraisers, and attorneys—whose work is used in an audit and which the amendment defines as members of the audit team. If an audit organization is not independent, the amendment states that the auditor should (1) decline to perform the work or (2) report the impairment in the scope section of the auditor's report when a government auditor cannot decline to perform the work because of a legislative requirement or for other reasons.

Amendment No. 3 adopts an engagement-team-focused approach to independence for matters such as financial interests of an individual auditor, not unlike the AICPA's Code of Conduct. It requires that audit organizations' internal quality control systems identify impairments to independence and determine compliance with Yellow Book independence requirements. Amendment No. 3 provides criteria for when governmental audit organizations are organizationally independent from the audited entity for purposes of external and internal reporting, expanding the previous criteria for when such organizations are independent for external reporting purposes.

Amendment No. 3 employs a principles-based approach to independence supplemented with certain safeguards for matters such as the performance of nonaudit services. With respect to nonaudit services, the Yellow Book rule is more restrictive than the AICPA rule because it prohibits an auditor from providing nonaudit services (except for routine advice or activities) when those services are significant or material to the subject matter of the audit. When the nonaudit service is not significant or material to the subject matter of the audit, specific safeguards are required, including a requirement for a separate engagement team to perform the service. The amendment's provisions relating to nonaudit services have the potential to significantly change auditor-client relationships.

The standard for nonaudit services employs two overarching principles:

1. Audit organizations should not provide nonaudit services that involve performing management functions or making management decisions; and
2. Audit organizations should not audit their own work or provide nonaudit services in situations where the nonaudit services are significant or material to the subject matter of the audits.

Audit organizations may perform nonaudit services that do not violate the above principles only if all of the following seven safeguards are followed:

1. The audit organization should preclude personnel who provided the nonaudit services from planning, conducting, or reviewing audit work related to the nonaudit service.
2. The audit organization is precluded from reducing the scope and extent of the audit work beyond the level that would be appropriate if another unrelated party performed the nonaudit work.
3. The audit organization should document its consideration of the nonaudit service, and document its rationale that providing the nonaudit service does not violate the two overarching principles.

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4. Before performing nonaudit services, the audit organization should establish and document an understanding with the audited entity regarding the objectives, scope of work, and product or deliverables of the nonaudit service. The audit organization should also establish and document an understanding with management that management is responsible for the substantive outcomes of the work.
 5. The audit organization's quality control systems for compliance with independence requirements should include policies and procedures to assure consideration of the effect on the ongoing, planned, and future audits when deciding whether to provide nonaudit services and a requirement to have the understanding with management of the audited entity documented. The understanding should be communicated to management in writing. Documentation must specify management's responsibility for the nonaudit service, management's qualifications to conduct the required oversight, and that management's responsibilities were performed.
 6. In cases where certain nonaudit services by their nature impair the audit organization's ability to meet either or both of the overarching principles for certain types of audit work, the audit organization should communicate to management of the audited entity, before performing the nonaudit service, that the audit organization would not be able to perform subsequent audit work related to the subject matter of the nonaudit service.
 7. For audits selected in the peer review, all related nonaudit services should be identified to the audit organization's peer reviewer and the audit documentation made available for peer review.

Help Desk—The AICPA has developed a fact sheet on Amendment No. 3 that discusses its provisions, including nonaudit services that may be performed and those that are expressly prohibited. In addition, the AICPA has developed a comparison of the AICPA and Yellow Book independence requirements. Both those documents, which are on the AICPA Web site at www.aicpa.org/members/div/ethics/index.htm, explain the dif-

ferences between the Yellow Book and AICPA independence requirements in general and for the following nonaudit services: bookkeeping, payroll, tax, human resources, information technology, appraisal or valuation, indirect cost proposal or cost allocation plans, legislative and administrative decision-making, internal control self-assessments, and assisting legislative bodies.

Possible Additional Guidance. When GAO issued Amendment No. 3, the AICPA immediately began receiving inquiries from members about the effect of the new requirement on the provision of nonaudit services to audit clients. Those questions were forwarded to the GAO staff. Subsequently, the GAO announced it would be providing additional guidance on the application of the amendment, most likely through the issuance of a question-and-answer document. Look for that guidance on the GAO Web site.

The Auditor's Response. Some auditors have asked what actions they should take now to address the provisions of the amendment, even though they do not yet apply. The following lists several actions an auditor could take in advance of the effective date of the amendment to help to ensure compliance. However, it may be prudent for you to wait until the GAO issues its clarifying guidance on Amendment No. 3 (as discussed above) before proceeding too far.

- Study and obtain an in-depth understanding of the requirements.
- Establish policies and procedures to ensure adherence with the provisions of the amendment.
- Examine current and potential future relationships with Yellow Book audit clients to identify nonaudit services that impair independence.
- Consider possible policies for choosing whether to continue to provide nonaudit services or, instead, audit services, to Yellow Book audit clients for which those nonaudit services would impair independence.

Omnibus Exposure Draft

In January 2002, the GAO issued an “omnibus” exposure draft (ED), *Government Auditing Standards 2002 Revision*, to propose revisions that would affect every chapter of the Yellow Book and to add a new chapter on attestation engagements. The proposed revisions would restructure the framework of the Yellow Book, apply standards consistently to the various types of audits, and strengthen and streamline the standards. Concerning the consistent application of Yellow Book standards, for example, the revisions would require (1) reporting on internal control and on fraud, illegal acts, and other noncompliance on attestation engagements and (2) documenting decisions related to internal control over data significantly dependent on computerized information systems on performance audits (consistent with the Yellow Book’s Amendment No. 1, *Documentation Requirements When Assessing Control Risk at Maximum for Controls Significantly Dependent Upon Computerized Information Systems*). Concerning strengthening and streamlining the standards, for example, the revisions would (1) require that audit organizations have a human capital management system and (2) permit agency views on significant findings, conclusions, and recommendations to be provided orally, rather than only in writing. The GAO said it anticipates the proposed revisions to become effective for financial audits of periods ending on or after January 1, 2003, and for attestation engagements and performance audits beginning on or after January 1, 2003. Comments on the proposals were requested by April 30, 2002. At this time, the GAO has not indicated when it expects to issue a final revision of the Yellow Book.

Internal Revenue Service Activities

Tax Exempt and Government Entities Division

In the Alerts for the past two years, we have reported how, as part of its modernization plan, the IRS created the Tax Exempt and Government Entities (TE/GE) Operating Division. TE/GE has three segments to deal separately with exempt organizations, employee plans, and governmental entities. The TE/GE’s governmental entities segment includes offices of Federal, State, and Local Govern-

ments (FSLG) and Indian Tribal Governments as well as the Tax Exempt Bonds (TEB) program.

The IRS continues to develop its Web site at www.irs.gov. That site provides contact information for the leadership of the TE/GE Division and has separate pages to serve the customers of the Exempt Organizations, Employee Plans, and Governmental Entities segments and the TEB program. For example, the TEB program page includes links to a description of the program's mission, organization, and personnel; tax-exempt bond legislation, regulations and other official pronouncements, and reporting forms; current program initiatives; the recently released publication 3755, "Tax-Exempt Bonds—Filing Requirements"; and a continuing professional education technical instruction program on tax-exempt bonds. The page indicates plans for future links.

We include the following topics to alert you to areas in which (1) noncompliance could have a direct and material effect on the determination of financial statement amounts or (2) you might observe changes in a government's activities relating to, for example, its retirement plans or tax-exempt debt.

Employment Issues

Worker Classification. In their efforts to reengineer and streamline operations, many governments are using independent contractors more frequently. The IRS, including the FSLG office, continues to consider the classification of workers as employees or, instead, as independent contractors to be an area with potentially significant compliance problems. Auditors should be alert to the potential financial statement effect of tax liabilities that may arise from inappropriate worker classification. All employers may be held liable for income taxes they fail to deduct and withhold if they treat an employee as an independent contractor. In addition, governmental employers who have employees subject to the Federal Insurance Contributions Act (FICA—Social Security and Medicare) may be liable for FICA taxes they fail to deduct and withhold, as well as the employer's match of FICA taxes, if they treat an employee as an independent contractor.

Using IRS Form SS8, “Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding,” an entity or worker can ask the IRS to determine whether a worker provides services as an employee or independent contractor. The IRS generally will issue a formal determination letter to the entity, and send a copy to the worker. A determination letter applies only to a worker (or a class of workers) requesting it, and the decision is binding on the IRS. The FSLG office recently started following up on determination letters issued to governmental entities to ascertain whether the situations are now in compliance with the IRS determination.

Payments to Independent Contractors. The FSLG office also is starting to focus on compliance problems associated with reporting payments to independent contractors. Payments of \$600 or more to independent contractors are subject to reporting to the contractor and to the IRS on Form 1099. The IRS imposes financial penalties if the payor fails to file correct 1099s in a timely manner in the required format. For the purpose of 1099 reporting, independent contractors are required to provide payors with correct taxpayer identification or Social Security numbers. If an independent contractor fails to provide a correct number, the payor generally is required to backup withhold 30 percent (after January 1, 2002) of the payment to the contractor and remit that amount to the IRS. The IRS imposes financial penalties on the payor if the payor fails to timely remit and report backup withholding amounts. If the payor fails to backup withhold as required, the payor can be assessed that amount during an examination.

Federal Insurance Contribution Act Taxes. Legislation enacted in the 1980s and 1990s greatly expanded the roles and responsibilities of state and local government employers with regard to FICA reporting and Social Security and Medicare coverage. Certain employees of many governments are now subject to full Social Security and Medicare coverage. Both the Social Security Administration (SSA) and the IRS are concerned that a sizable number of public employers may not be accurately reporting the Social Security coverage status of their employees due to the complex law,

complicated changes in the coverage provisions of Section 218 of the Social Security Act, and a diminished role of Social Security administrators.

The problem that results from noncompliance is that the SSA is obligated to pay retroactive coverage and benefits even though public employers have not paid FICA taxes into the trust funds. You should be aware that the governments you audit might be liable for past taxes that should have been paid to the trust fund. The IRS is using education and outreach to encourage governments to voluntarily identify and correct their reporting of the Social Security coverage status of their employees. With voluntary compliance, the IRS is less likely to pursue payment of back taxes. Although the IRS expects that strategy to bring most governmental employers into voluntary compliance, it may conduct examinations if education and outreach is unsuccessful in obtaining voluntary compliance.

Help Desk—An IRS publication, *Federal-State Reference Guide: Social Security Coverage and FICA Reporting by State and Local Government Employers*, is available on the IRS Web site at www.irs.gov/pub/irs-pdf/p963.pdf. That publication, which is expected to be updated in 2002, provides a comprehensive reference source for Social Security and Medicare coverage and FICA tax withholding issues for state and local governments.

Employee Business Expense Reimbursements. The FSLG office has started a process of education, outreach, and examination in the area of employee business expense reimbursements, which it believes is an area with potential compliance problems. Whether expense reimbursements or allowances represent taxable income to employees depends on whether the employer has an accountable or a nonaccountable plan. Amounts paid under an accountable plan are not wages and, therefore, are not subject to income tax withholding and payment of employment taxes. If the employee does not substantiate the expenses or return amounts in excess of expenses to the employer within a reasonable period of time, amounts are treated as paid under a nonaccountable plan and are subject to income tax withholding and the payment of employment taxes.

Help Desk—IRS Publication 15, *Circular E, Employer's Tax Guide*, defines accountable and nonaccountable plans. It is available on the IRS Web site at www.irs.gov.

Family and Medical Leave Act and Cafeteria Plans. In the October 17, 2001, *Federal Register* (66 FR 52676), the IRS published final regulations relating to cafeteria plans² that reflect changes made by the Family and Medical Leave Act of 1993 (FMLA). The regulations apply to cafeteria plan years beginning on or after January 1, 2002. The regulations, which are consistent with the DOL's regulations relating to the FMLA, are written in a question-and-answer form and address, among others, the following issues:

- Whether employees may revoke coverage or cease payment of group health plan premiums when taking unpaid FMLA leave
- Who is responsible for paying premium payments when an employee on leave continues group health plan coverage
- The payment options required or permitted to be offered to an employee who continues group health plan coverage while on unpaid leave, and the tax treatment of those payments
- How FMLA requirements concerning the payment of premiums by an employee who continues group health plan coverage apply if the employee is on paid leave
- The restrictions that apply to contributions when an employee's leave spans two cafeteria plan years

Employer Reimbursements for Certain Salary Reduction Amounts. In some situations, employees enter into salary reduction agreements to pay health insurance premiums, and the employers reimburse the employees for those amounts. In other words, the employer is reimbursing the employees for amounts that already have been treated as tax advantaged; that arrangement is giving the employees a double benefit. In Revenue Ruling 2002-3 (*Internal*

2. A cafeteria plan is a written plan that allows employees to choose between receiving cash or taxable benefits instead of certain qualified benefits that are excluded from wages.

Revenue Bulletin 2002-3, January 22, 2002), the IRS clarifies that those reimbursements should be included in the employees' gross income, subjecting them to employment taxes. A proper benefit, such as is obtained by paying such premiums through a cafeteria plan, is not being challenged in this ruling; it is the effort to provide a double benefit that is being prohibited.

Back Wages. In April 2001, the Supreme Court issued a ruling (*United States v. Cleveland Indians Baseball Co.*, No. 00-203) in which it determined that back wages are subject to employment taxes by reference to the year the wages are paid, rather than by reference to the year they should have been paid. Governments may pay back wages, for example, in connection with a judicial finding of discriminatory compensation. If an employer fails to withhold appropriate employment taxes from the payments, the employer remains liable for the taxes, although the employer has a legal right to recover the taxes paid from the employees.

Tax-Exempt Bonds

Enforcement Activities. Tax-exempt bond (TEB) issuances are subject to myriad IRS requirements. In recent years, the IRS has significantly expanded its enforcement activities relating to tax-exempt bonds, including reviews for yield burning and arbitrage as well as for the appropriate use of bond proceeds.

- Yield burning occurs when the prices governments pay for securities (usually escrow securities on refunded bonds) are artificially inflated to lower the investment yield, thus avoiding arbitrage profits. The IRS has generally directed its enforcement activities to date towards securities broker-dealers and has entered into a number of global settlements with individual firms with respect to similarly situated issuers.
- Arbitrage is the excess profit earned from the investment of tax-exempt bond proceeds in taxable obligations at a yield that is higher than the yield on the bonds. Arbitrage profits are prohibited in refunding escrows. Even where allowed, an issuer's arbitrage earnings must be periodically "rebated" to the federal government unless one of a number of specific exceptions applies. (See the discussion of a change in one of

the arbitrage rebate exemptions in the later section of this Alert entitled “Tax-Exempt Financing for Public Schools.”)

As part of this year’s educational efforts, the TEB program is planning to issue a publication that discusses tax-exempt bond compliance requirements. As part of this year’s examination efforts, the TEB program is focusing on bonds for solid waste recycling, multifamily housing, and single-family housing and is planning correspondence examinations on tax-exempt governmental obligations. You should be alert to instances of noncompliance with federal requirements concerning tax-exempt debt, including errors in calculating arbitrage rebate, because they could have a direct and material effect on the determination of an issuer’s financial statement amounts. Because of the complexity of those requirements, you should consider giving increased audit scrutiny to this area as well as consulting a tax-exempt debt specialist.

Help Desk—In its August 2001 *Government Finance Review*, the Government Finance Officers Association published an article entitled “What to Do When the IRS Audits Your Bonds.” If the IRS sends an audit letter to one of your governmental clients, management may benefit from reading that description of the process involved in an IRS audit of tax-exempt bonds.

Voluntary Closing Agreement Program. In Notice 2001-60 (*Internal Revenue Bulletin* 2001-40, October 1, 2001), the IRS provides information about a new voluntary closing agreement program for tax-exempt bonds. The Voluntary Closing Agreement Program (VCAP) will allow bond issuers and conduit borrowers to correct violations of the tax law and regulations on tax-exempt bonds when the current regulations and existing tax-exempt bond closing agreement programs do not provide a remedy. VCAP is administered by the TEB outreach, planning, and review office and reflects the continuing policy of the IRS to try to resolve violations of the tax law without taxing bondholders.

To encourage issuers and other parties to bond transactions to voluntarily come to the IRS to resolve problems, Notice 2001-60 explains that an issuer or issuer’s representative may anonymously initiate preliminary discussions of a closing agreement. Specific closing agreement terms under VCAP will depend on the facts and

circumstances of each case, including the degree of diligence exercised by the issuer and conduit borrowers.

The IRS anticipates that VCAP will be refined and that more detailed procedures will be developed in the future. For that purpose, the notice also asks for comments from the public on the program and existing closing agreement programs and procedures.

Private Activity Bonds. In the November 20, 2001, *Federal Register* (66 FR 58061), the IRS issued regulations that change the length of time that issuers of tax-exempt municipal bonds may contract with nongovernmental entities to use property financed with tax-exempt debt without running afoul of private-use restrictions. The regulations allow bond issuers to enter into contracts with nongovernmental entities lasting up to 50, 100, or 200 days, depending on the circumstances. The previous contract limits were 30, 60, and 90 days. The regulations apply to both new and outstanding bonds.

Disaster Relief. In Announcement 2001-101 (*Internal Revenue Bulletin* 2001-43, October 22, 2001), the IRS provided certain issuers of tax-exempt bonds affected by the September 11 terrorist attacks with additional time to file certain information returns and arbitrage rebate returns. Affected issuers (as listed below) who had an original filing or payment deadline between September 11, 2001, and November 30, 2001, were given an additional 6 months plus 120 days to file the return and make any payment due with the return. In addition to those provisions, the IRS will grant relief to affected issuers under other appropriate circumstances.

Affected issuers are those located in one of the counties covered by federal disaster declarations (covered counties) or for which at least one of the following is located in a covered county:

- The conduit borrower
- Records needed to meet the filing or payment deadline
- The facilities financed with the debt proceeds
- The professional on whom the issuer relies for compliance (such as the bond trustee, a financial adviser, or rebate consultant) or bond counsel for the issuer or conduit borrower

Employee Plans

Education and Outreach. The TE/GE Division's Employee Plans (EP) segment continues to "ramp up" its education and outreach program. In last year's Alert, we described the Section 403(b) Tax-Sheltered Annuity Partnership for Compliance, whereby IRS employees are available to provide educational services relating to 403(b) plans, including delivering speeches, participating in panel discussions, conducting training sessions, and helping to prepare newsletter articles. In 2002, EP plans to expand the program to include section 457 retirement plans. A visit to the retirement plans page on the IRS Web site also could be very enlightening. The page has a wealth of information for governmental plans, including a quarterly EP newsletter, a resource disk of information concerning 403(b) and 457 plans, the opportunity to order a free educational video on the plans, and information about the Employee Plans Compliance Resolution System, which we discussed in detail in last year's Alert.

Help Desk—The retirement plans page on the IRS Web site is at www.irs.gov/ep.

Pension Reform. The Economic Growth and Tax Relief Reconciliation Act of 2001 included comprehensive pension reforms that significantly changed how traditional retirement programs are operated, including programs that cover governmental employees. The reforms concern enhanced pension portability and higher contribution limits. The following discussion provides some of the significant changes relevant to section 403(b) and section 457 plans. Many governmental entities offer these plans to their employees, and you may observe significant changes in the amounts contributed to and withdrawn from these plans. Further, improper administration of these plans may affect a governmental employer's obligation under the tax code to properly collect income tax withholdings.

Pension portability concerns a participant's ability to move (or "roll over") assets from one type of retirement account to another. Before the Act, eligible distributions from 403(b) plans could only be rolled over to another 403(b) plan or to an IRA, and eligible distributions from 457 plans could only be rolled over to other 457

plans. Under the Act, eligible rollover distributions can be rolled over with no tax consequences to various similar plans, such as other 403(b) and 457 plans, IRAs, qualified annuities, and other tax-qualified retirement plans. Further, employees participating in state and local government retirement plans may use assets from 403(b) and 457 plans to purchase service credits for prior employment. These and other enhanced portability provisions became effective for distributions after December 31, 2001.

The maximum amounts that employees may contribute to (defer into) 403(b) and 457 plans increase and become the same starting in 2002, as shown in the following chart:

2001	2002	2003–2006	2007–2010
For 403(b) plans, generally \$10,500	\$11,000	Increases	Inflation
For 457 plans, generally the lesser of \$8,500 or 33 1/3% of compensation		\$1,000 annually	increases in \$500 increments

Both 403(b) and 457 plans have increased contribution limits for certain employees. The increased limits differ for the two types of plans but, generally, involve employees who are age 50 or older, have a certain number of years of service, or are nearing retirement. In 2001, a participant’s contribution to a 457 plan was limited by deferrals into other retirement plans, such as a 403(b) plan. The Act repeals that coordination provision for 457 plan contributions in 2002 and thereafter.

The Act is set to expire on December 31, 2010. It will not be effective in 2011 and thereafter and the laws governing employee benefit plans will revert back to pre-Act (2001) requirements on January 1, 2011, unless further legislation is passed.

The IRS is issuing guidance relating to the implementation of the provisions of the Act affecting retirement plans. Guidance relating to 403(b) and 457 plans includes:

- The IRS proposed regulations concerning increased contribution limits (“catch up” contributions) for individuals age 50 and older in the October 23, 2001, *Federal Register* (66 FR 53555).

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- The IRS provides “safe harbor explanations” that administrators of 403(b) and 457 plans may provide to recipients of eligible rollover distributions, as provided for in the Act, in Notice 2002-3 (*Internal Revenue Bulletin* 2002-2, January 14, 2002).

The IRS also is expected to issue proposed regulations on 457 plans in 2002.

Qualified Tuition Programs

Qualified tuition programs, which are administered by state governments, permit participants to pay currently for or to save money towards future college costs in tax-advantaged programs. The IRS recently provided guidance regarding the restrictions on investment direction for qualified tuition programs under Internal Revenue Code section 529, which addresses the extent to which contributors and beneficiaries direct investment under the program. Consequently, you may observe changes in a program’s investment mix.

In Notice 2001-55 (*Internal Revenue Bulletin* 2001-39, September 24, 2001), the IRS announced that final regulations under section 529 are expected to permit a change in the investment strategy selected once per calendar year or upon a change in the designated beneficiary of the account. The notice indicates that section 529 programs and participants may rely on its guidance pending the issuance of final regulations.

Tax-Exempt Financing for Public Schools

The Economic Growth and Tax Relief Reconciliation Act of 2001 (the Act) increases the small issuer arbitrage rebate exemption for school construction from \$5 million to \$10 million. That provision, which is effective for bonds issued after December 31, 2001, permits governments to issue up to \$15 million in bonds annually and not have those bonds subject to arbitrage requirements, provided \$10 million of the bonds are used to finance public school construction expenditures.

The Act also provides for a new public-private partnership whereby developers can use tax-exempt bond financing to construct, rehabilitate, refurbish, or equip privately owned elementary and secondary public school facilities. The facility has to be leased to a state or local educational agency under terms that will transfer the facility to the agency at the end of the term of the lease (which can be no longer than the financing term) for no additional consideration. This is a small program—limited each year in any particular state to the greater of \$10 times the state’s population or \$5 million. However, this program may allow some school districts to acquire facilities quickly by avoiding the need to have a citizens’ vote to approve the issuance of bonds. You may observe capital improvements financed through this new provision. (The earlier sections of this Alert entitled “The State of the Economy” and “Internal Revenue Service Activities” discuss the effect of other provisions of the Act on state and local governments.)

Securities and Exchange Commission and Municipal Securities Developments

The Securities and Exchange Commission (SEC) has no authority to regulate the disclosure of information by municipal securities issuers except through the antifraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934. Although the SEC has no recent releases relating to the municipal securities market, we want to alert you to some developments relating to the SEC and municipal securities.

Open Letter on the Effects of September 11 on Municipal Securities

The SEC’s Office of Municipal Securities published an open letter to the municipal securities industry concerning the role of municipal bonds in the nation’s economic recovery from the September 11 terrorist attacks. The letter explained how the adequacy of revenue sources and cash flows pledged to support bond payments had been cast in doubt by the sudden decline in travel and other changes in the normal activities of Americans. “The rumor mill,” the letter said, “is full of dire predictions about the creditworthiness of many bond issues and the financial futures of their issuers and

borrowers. Frequently the facts do not support such a negative outlook. The known can be dealt with. The unknown generates fear.” The letter encouraged issuers and conduit borrowers to go beyond the primary and secondary market disclosures required by law or contract to provide timely and accurate material information. (See also the discussion in the earlier section of this Alert entitled “The State of the Economy” concerning the auditor’s consideration of the entity’s ability to continue as a going concern.)

Help Desk—The SEC’s open letter to the municipal securities industry is available on the Internet at www.sec.gov/info/municipal/sept11letter.htm.

Auditor Association With the Issuance of Municipal Securities

The new Audit and Accounting Guide *Audits of State and Local Governments* (GASB 34 Edition) expands its discussion of situations in which an auditor becomes associated with an official statement or other offering document for the issuance of municipal securities and, thus, when the auditor should refer to SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 550). (See the discussion of the new Guide in the section of this Alert entitled “Revision of Audit and Accounting Guides for GASB Statement No. 34.”) The auditor of a government’s financial statements becomes associated with its official statement in any of the following situations:

1. Assisting in preparing the financial information included in the official statement.
2. Reviewing a draft of the official statement at the government’s request.
3. Manually signing the independent auditor’s report included in the official statement.
4. Providing a revised independent auditor’s report³ for inclusion in a *specific* official statement.

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3. A revised report would, for example, eliminate the references made by the auditor in the original report to (1) required or other supplementary information that had accompanied the basic financial statements or (2) the audit and reports required by *Government Auditing Standards*.

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5. Providing written agreement for the use of the independent auditor's report in the official statement.
 6. Issuing a comfort letter, the letter described in SAS No. 76, *Amendments to SAS No. 72, Letters for Underwriters and Certain Other Requesting Parties* (AICPA, *Professional Standards*, vol. 1, AU sec. 634.09), or an attestation engagement report in lieu of a comfort or similar letter on information included in the official statement.
 7. Issuing a report on an attestation engagement relating to the debt offering (see also the following discussion on those attestation engagements).

Additional details about those seven situations are provided in the new Guide. If the auditor is associated with an official statement, the guidance in SAS No. 8 provides that the auditor has no obligation to perform any procedures to corroborate other information contained in that document. However, the auditor should read the other information and consider whether that information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements. SAS No. 8 (AICPA, *Professional Standards*, vol. 1, AU sec. 550.04–.06) provides guidance if the auditor concludes there is a material inconsistency or a material misstatement of fact that is not a material inconsistency. Although an auditor is not required to become associated with a government's official statements except in the situations described above, some auditors include a provision in the engagement letter requiring the government to obtain permission from the auditor before using the independent auditor's report in the official statement. Such a provision establishes a requirement that the auditor become associated with the government's official statements.

Continuing Disclosures

The SEC has identified continuing (secondary market) disclosures by municipal securities issuers and conduit borrowers as an issue and is working with various industry groups to try to improve compliance with applicable SEC requirements. The SEC is con-

cerned that some municipal securities issuers and conduit borrowers are not providing the required disclosures, or that the information disclosed is “stale” or does not accurately reflect a deteriorating financial condition.

The SEC’s Rule 15c2-12 (17 CFR Part 240.15c2-12) and associated SEC Releases impose certain requirements on the underwriters of municipal securities. Because of Rule 15c2-12, issuers of most municipal securities offerings over set dollar amounts provide continuing disclosures. Continuing disclosures are made by providing to distributing organizations (the nationally recognized municipal securities information repositories and a state information depository, if one exists in the issuer’s state), (1) annual⁴ continuing disclosures as contractually established and (2) material events notices. Annual continuing disclosures are financial information, including audited financial statements that are updated annually. Material events notices, which are required for 11 specific events with respect to municipal securities, such as principal and interest payment delinquencies and nonpayment related defaults, are provided through a press release or other written notification on an “as needed” basis and do not involve financial statements. Issuers are required to notify the distributing organizations of material events in a “timely” manner.

Help Desk—The National Federation of Municipal Analysts (NFMA) is issuing a series of “best practices” guidelines on continuing disclosures for various sectors of the municipal securities market (such as general obligation debt, hospital bonds, and housing revenue debt). The SEC has expressed its support for the NFMA’s voluntary disclosure initiative, which is intended to be used in conjunction with the regulatory guidance provided in Rule 15c2-12. The NFMA guidelines describe the sector-specific financial and operating information needed to help analysts do their jobs. The guidelines are available on the NFMA Web site at www.nfma.org under the “disclosure guidelines” link.

4. Although not required, financial conditions in certain sectors (such as health care) may make it advisable for municipal securities issuers and conduit borrowers to make continuing disclosures more frequently than annually.

As provided in the new Audit and Accounting Guide, the auditor is not required to participate in, or undertake any procedures with respect to, a government's continuing disclosure documents, even though they may include audited financial statements. (See the discussion of the new Guide in the section of this Alert entitled "Revision of Audit and Accounting Guides for GASB Statement No. 34.") A government's continuing disclosures are not required to be submitted to or disseminated from the distributing organizations as a single document and, thus, an auditor's association with other information encompassed by such disclosures cannot be clearly established. Therefore, the provisions of SAS No. 8 do not apply to documents that contain those disclosures. Any attention the auditor devotes to other information included with audited financial statements in continuing disclosure documents at the government's request should be considered a consulting engagement under the provisions of the AICPA Statement on Standards for Consulting Services (AICPA, *Professional Standards*, vol. 2, CS sec. 100).

That said, however, you may become aware during the audit of a government's financial statements that the government has not complied with its continuing disclosure obligations. SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), describes the auditor's responsibility for detecting, considering the financial statement effects of, and reporting illegal acts that have a material indirect effect on the financial statements. A government's failure to meet its continuing disclosure obligations might have a material indirect effect on the financial statements because of the provisions of National Council on Governmental Accounting (NCGA) *Interpretation 6, Notes to the Financial Statements Disclosure*, and GASB Statement No. 38, *Certain Financial Statement Note Disclosures*. Those standards require that the notes to the financial statements disclose material violations of finance-related legal and contractual provisions and actions taken to address those violations. If, because of procedures applied for the purpose of forming an opinion on the financial statements (including inquiries of management and

written management representations), you become aware that the government has not complied with its continuing disclosure obligations, you should consider the adequacy of the government's disclosures in the financial statements about those violations and the effect of nondisclosure on the auditor's report.

Attestation Engagements Relating to the Issuance of Municipal Securities

The new Audit and Accounting Guide introduces a discussion of attestation engagements relating to the issuance of municipal securities. During the process of issuing municipal securities, governments or other involved parties often engage auditors to provide certain needed information. For example, a government or its bond counsel may engage an auditor to review the government's compliance with the revenue coverage requirements on outstanding bonds or to verify the calculation of escrow account requirements for an advance refunding of bonds. The Guide explains that those engagements should be conducted in accordance with SSAE No. 10, *Attestation Standards: Revision and Recodification*, as amended (AICPA, *Professional Standards*, vol. 1, AT secs. 101-701). If the auditor of the financial statements included in the official statement also provides an attestation engagement report relating to a debt offering, that establishes an association with the official statement, as indicated in the previous discussion on auditor association with the issuance of municipal securities. An attestation engagement report relating to a debt offering need not be referred to or included in the official statement to associate the auditor of the financial statements with the official statement. Sometimes the attestation engagement report may only be included in the official closing documents for the offering. Also, if the practitioner providing the attestation engagement report is not the auditor of the financial statements included in the official statements, the issuance of the attestation engagement report does not by itself associate either the auditor of the financial statements or the practitioner who issued the attestation report with the official statement.

Audit and Attestation Issues and Developments

Recent Auditing Standards and Other Guidance

SAS No. 94, The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit

In May 2001, the AICPA's Auditing Standards Board (ASB) issued SAS No. 94, *The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319). SAS No. 94 is an amendment to SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*. SAS No. 94 is effective for audits of financial statements for periods beginning on or after June 1, 2001. Earlier application is permitted.

SAS No. 94 indicates that, in obtaining an understanding of internal control sufficient to plan the audit, the auditor should consider how an entity's use of IT and manual procedures might affect controls relevant to the audit to assess control risk. SAS No. 94:

- Incorporates and expands the concept from SAS No. 80, *Amendment to Statement on Auditing Standards No. 31*, Evidential Matter (AICPA, *Professional Standards*, vol. 1, AU sec. 326.14), that in circumstances where a significant amount of information supporting one or more financial statement assertions is electronically initiated, recorded, processed, and reported, the auditor may determine that it is not practical or possible to restrict detection risk to an acceptable level by performing only substantive tests for one or more financial statement assertions. In such circumstances, the auditor should obtain evidential matter about the effectiveness of both the design and operation of controls to reduce the assessed level of control risk.
- Describes how IT may affect internal control, evidential matter, and the auditor's understanding of internal control and assessment of control risk.
- Describes both the benefits and risks of IT to internal control, and how IT affects the components of internal control,

particularly the control activities and information and communication components.

- Provides guidance to help auditors determine whether specialized skills are needed to consider the effect of computer processing on the audit, to understand the controls, or to design and perform audit procedures.
- Clarifies that in obtaining an understanding of the entity's financial reporting process, the auditor should understand how both standard, recurring entries and nonstandard, non-recurring entries are initiated and recorded, and also should understand the controls that have been placed in operation to ensure that such entries are authorized, complete, and correctly recorded.
- Updates terminology and references to IT systems and controls.

SAS No. 94 does not eliminate the alternative of assessing control risk at the maximum level and performing a substantive audit, if that is an effective approach. However, it notes that when evidence of an entity's initiation, recording, or processing of financial data exists only in electronic form, an auditor's ability to obtain the desired assurance only from substantive tests would significantly diminish. SAS No. 94 also does not change the requirement to perform substantive tests for significant account balances and transaction classes. (See also the later section of this Alert entitled "Information Systems Security Auditing Guidance.")

SAS No. 95, *Generally Accepted Auditing Standards*

In December 2001, the ASB issued SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150). SAS No. 95 supersedes "Generally Accepted Auditing Standards" of SAS No. 1, *Codification of Auditing Standards and Procedures*. SAS No. 95 is effective for audits of financial statements for periods beginning on or after December 31, 2001.

SAS No. 95 establishes a hierarchy of generally accepted auditing standards (GAAS) consisting of auditing standards, interpretive publications, and other auditing publications.

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- *Auditing Standards* are comprised of the general, field work, and reporting standards approved and adopted by the AICPA membership, as amended by the ASB, as well as the SASs. The auditor should be prepared to justify departures from the SASs.
 - *Interpretive Publications* consist of auditing Interpretations of the SASs, auditing guidance included in the AICPA Audit and Accounting Guides, and AICPA auditing SOPs. The auditor should be aware of and consider applicable interpretive publications. If the auditor does not apply the auditing guidance included in an applicable interpretive publication, the auditor should be prepared to explain how he or she complied with the SAS provisions addressed by such auditing guidance.
 - *Other Auditing Publications* include AICPA auditing publications not referred to above as well as auditing articles in the *Journal of Accountancy* and other professional journals; auditing articles in the *AICPA CPA Letter*; continuing professional education programs and other instruction materials; textbooks; and so forth. Although other auditing publications have no authoritative status, they may help the auditor understand and apply the SASs. The auditor is not expected to be aware of the full body of other auditing publications.

SAS No. 96, *Audit Documentation*

In January 2002, the ASB issued SAS No. 96, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339). SAS No. 96 supersedes SAS No. 41, *Working Papers*, and amends three SASs as discussed below. SAS No. 96 is effective for audits of financial statements for periods beginning on or after May 15, 2002. Earlier application is permitted.

SAS No. 96 supersedes SAS No. 41 by using the term *audit documentation* instead of *working papers* to describe the principal record of auditing procedures applied, evidence obtained, and conclusions reached by the auditor in an audit engagement. (Note, however, that SAS No. 96 permits the term *working papers* to be used to refer to audit documentation.) SAS No. 96 also:

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- Does not change the requirement in SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311), for a written audit program (or set of audit programs) for every audit.
 - Introduces the concept that audit documentation should (1) enable members of the engagement team with supervision and review responsibilities to understand the nature, timing, extent, and results of auditing procedures performed, and the evidence obtained, and (2) indicate the engagement team member(s) who performed and reviewed the work.
 - Explains that review of audit documentation and discussions with engagement team members are among the procedures a firm performs when monitoring compliance with the quality control policies and procedures that it has established.
 - Lists factors that the auditor should consider in determining the nature and extent of the audit documentation to be prepared for a particular audit area or auditing procedure.
 - Requires audit documentation to include abstracts or copies of significant contracts or agreements examined and, for tests of operating effectiveness of controls and substantive tests of details that involve inspection of documents or confirmation, requires audit documentation to include an identification of the items tested.
 - Requires documentation of audit findings or issues that in the auditor's judgment are significant, actions taken to address them (including any additional evidence obtained), and the basis for the final conclusions reached. (SAS No. 96 includes a list of types of significant audit findings and issues.)
 - Requires the auditor to adopt reasonable procedures to prevent unauthorized access to the audit documentation.
 - Lists the audit documentation requirements in other SASs.

In addition to superseding SAS No. 41, SAS No. 96 amends:

- SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312),

by requiring the auditor to document the nature and effect of misstatements that the auditor aggregates as well as the auditor's conclusion as to whether the aggregated misstatements cause the financial statements to be materially misstated.

- SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329), by requiring the auditor to document, when an analytical procedure is used as the principal substantive test of a significant financial statement assertion, (1) the expectation, where that expectation is not otherwise readily determinable from the documentation of the work performed, and factors considered in its development; (2) results of the comparison of the expectation to the recorded amounts or ratios developed from recorded amounts; and (3) any additional auditing procedures performed in response to significant unexpected differences arising from the analytical procedure and the results of such additional procedures.
- SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341), by requiring the auditor to document (1) the conditions or events that led him or her to believe that there is substantial doubt about the entity's ability to continue as a going concern; (2) the work performed in connection with the auditor's evaluation of management's plans; (3) the auditor's conclusion as to whether substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains or is alleviated; and (4) the consideration and effect of that conclusion on the financial statements, disclosures, and the audit report.

Auditing Interpretations

Sometimes, governments are service organizations for other entities and obtain service auditor reports on their transaction processing. In addition, governments often use service organizations and their auditors consider service auditor reports during the audits of the financial statements of the user organizations. In February 2002, the ASB issued three interpretations of SAS No. 70,

Service Organizations, that concern how service auditors perform and report on those examinations:

- Interpretation No. 4, “Responsibilities of Service Organizations and Service Auditors With Respect to Forward-Looking Information in a Service Organization’s Description of Controls,” of SAS No. 70 (AICPA, *Professional Standards*, vol. 1, AU sec. 9324.35-.37)
- Interpretation No. 5, “Statements About the Risk of Projecting Evaluations of the Effectiveness of Controls to Future Periods,” of SAS No. 70 (AICPA, *Professional Standards*, vol. 1, AU sec. 9324.38-.40)
- Interpretation No. 6, “Responsibilities of Service Organizations and Service Auditors With Respect to Subsequent Events in a Service Auditor’s Engagement,” of SAS No. 70 (AICPA, *Professional Standards*, vol. 1, AU sec. 9324.41-.42)

Those Interpretations address:

- The service auditor’s responsibility to identify in his or her report design deficiencies that may represent potential problems in future periods but that do not affect processing during the period covered by the service auditor’s examination.
- The expansion of the service auditor’s report to describe the risk of projecting to the future conclusions about the effectiveness of controls.
- The service auditor’s responsibility for changes in service organization controls that happen after the period covered by the service auditor’s report but before the date of that report.

In April 2002, the ASB issued Interpretation No. 12, “The Effect on the Auditor’s Report of an Entity’s Adoption of a New Accounting Standard That Does Not Require the Entity to Disclose the Effect of the Changes in the Year of Adoption,” of SAS No. 1, section 420, “Consistency of Application of Generally Accepted Accounting Principles” (AICPA, *Professional Standards*, vol. 1, AU sec. 9420.69-.72), which provides guidance to the auditor in determin-

ing materiality for purposes of applying the consistency standard when an accounting standard does require the entity to disclose, and the entity has not disclosed or determined, the effect of the change in accounting principle in the year of adoption. Recent GASB standards require disclosure of the effect of changes in accounting principles in the year of adoption, but this Interpretation may be applicable to future GASB standards or to Financial Accounting Standards Board (FASB) standards that governments adopt using the provisions of GASB Statements No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, paragraph 7, and No. 34, paragraph 17.

General Audit Guides Issued

The AICPA has issued two general Audit Guides that are applicable to audits of state and local governments. Issued in June 2001, *Analytical Procedures*, which revises and replaces an Auditing Practice Release, provides practical guidance to auditors on the effective use of analytical procedures. The guide includes a discussion of SAS No. 56; concepts and definitions; a series of questions and answers; and a case study illustrating trend analysis, ratio analysis, reasonableness testing, and regression analysis. Issued in April 2001, *Service Organizations: Applying SAS No. 70, as Amended*, also revises and replaces an Auditing Practice Release. The guide includes a discussion of SAS No. 70, as amended; audit considerations for an entity that uses service organizations; the form and content of service auditors' reports; the performance of a service auditor's engagement; and examples of service auditors' reports.

Related-Party Toolkit

The AICPA staff has developed an electronic document, *Accounting and Auditing for Related Parties and Related Party Transactions: A Toolkit for Accountants and Auditors*, to provide accountants and auditors of private-sector business enterprises with an overview of selected authoritative accounting and auditing literature, SEC requirements, and nonauthoritative best practice guidance concerning related parties and related-party transactions. Although the toolkit does not specifically consider accounting and financial re-

porting standards for governmental entities, auditors of state and local governments should find much of its material useful. Governmental officials and management are becoming more sensitive to independence and related-party issues and possible conflicts between the government and parties with which it does business. Identifying related parties and related-party transactions is an important aspect of a financial statement audit because of:

- Generally accepted accounting principles (GAAP) requirements to disclose material related-party transactions and certain control relationships.
- The potential for distorted or misleading financial statements in the absence of adequate disclosures.
- The instances of fraudulent financial reporting and misappropriation of assets that have been facilitated by the use of an undisclosed related party.

The toolkit, which draws heavily from AICPA Practice Alert No. 95-3, *Auditing Related Parties and Related Party Transactions*, contains illustrative checklists and related-party letters.

Help Desk—The related-party toolkit is available on the AICPA Web site at ftp.aicpa.org/public/download/news/relpty_toolkit.doc.

Audit Risk Factors

In January 2002, the five largest accounting firms and the AICPA released a detailed list of “risk factors” that should be considered as businesses prepare their 2001 financial statements. Although written to address the risk factors of for-profit entities, management and auditors of state and local governments should find much of the document’s material useful. The current economic downturn, events of September 11, and recent business failures have combined to create a troubled financial reporting environment. Among the specific financial reporting issues addressed by the risk assessment document are liquidity and viability (going concern); changes in internal control, unusual transactions, related parties, off-balance sheet arrangements, materiality, and adequate disclosure. The document also recommends actions that can be taken to address such financial reporting risks.

Help Desk—The risk assessment document is available on the AICPA Web site at ftp.aicpa.org/public/download/news/risk_factor.doc.

Proposed Auditing Standards

In February 2002, the ASB issued an ED of a proposed SAS, *Consideration of Fraud in a Financial Statement Audit*, to establish standards and provide guidance to auditors in fulfilling their responsibility as it relates to fraud in an audit of financial statements conducted in accordance with generally accepted auditing standards. The proposed SAS, which would be effective for audits of financial statements for periods beginning on or after December 15, 2002, would:

- Supersede SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), and amend SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 230, “Due Professional Care in the Performance of Work”).
- Not change the auditor’s responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud (as described in SAS No. 1 [AICPA, *Professional Standards*, vol. 1, AU sec. 110.01, “Responsibilities and Functions of the Independent Auditor”]). However, the proposed SAS would establish standards and provide guidance to auditors in fulfilling that responsibility, as it relates to fraud.

The ASB believes that the requirements and guidance provided in the proposed SAS, if adopted, would result in a substantial change in the auditor’s performance and thereby improve the likelihood that auditors will detect material misstatements due to fraud in a financial statement audit. The ASB also believes that the proposed SAS’s adoption would result in an increased focus on professional skepticism in the consideration of the risk of fraud in a financial statement audit. In its summary, the proposed SAS discusses the changes in the auditor’s consideration of fraud that would result from the adoption of the proposed SAS as contrasted with SAS No. 82. Those changes

would include, for example, expanded inquiries of management and others within the entity and extended documentation requirements.

In early 2002, the ASB issued an ED, *Omnibus—2002*, that contains accumulated proposed revisions to various SASs and SSAEs. The proposals relating to SAS No. 8, *Other Information in Documents Containing Audited Financial Statements*, SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1, AU sec. 551), and SAS No. 52, *Omnibus Statement on Auditing Standards—1987* (AICPA, *Professional Standards*, vol. 1, AU sec. 558, “Required Supplementary Information”), are particularly relevant to audits of governmental entities. Those proposals indicate when an auditor may issue a report providing an opinion, in relation to the basic financial statements taken as a whole, on supplementary information and other information that has been subjected to auditing procedures applied in the audit of the basic financial statements.

Recent Attestation Standards

In January 2002, the ASB issued SSAE No. 11, *Attest Documentation* (AICPA, *Professional Standards*, vol. 1, AT secs. 101-701). SSAE No. 11 amends SSAE No. 10 to incorporate the concepts and terminology in SAS No. 96, as discussed in the earlier section of this Alert entitled “Recent Auditing Standards and Other Guidance.” SSAE No. 11 is effective for attest engagements when the subject matter or assertion is as of or for a period ending on or after December 15, 2002. Earlier application is encouraged.

2002 Audit and Accounting Guide and SOP 98-3 Conforming Changes

We have updated the AICPA’s 1994 Audit and Accounting Guide *Audits of State and Local Governmental Units* (Non-GASB 34 Edition) as well as SOP 98-3,⁵ which appears as an appendix to the

5. Statement of Position (SOP) 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, is updated annually for conforming changes. Although the AICPA does not normally make conforming changes to SOPs, SOP 98-3 has been, and will continue to be, revised annually to keep it up-to-date for changes in the Yellow Book, single audit literature and processes, and SASs.

Guide, for conforming changes as of May 1, 2002. We made revisions for SAS No. 94 and added information alerting auditors to the issuance of SAS No. 95 and No. 96 and the *Government Auditing Standards* Amendment No. 3, *Independence*. The Guide continues to explain why it has not incorporated the provisions of GASB Statement No. 34, *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments*, and related pronouncements. (See the discussion about the Guide revision for GASB Statement No. 34 in the next section of this Alert, “Revision of Audit and Accounting Guides for GASB Statement No. 34.”)

Even though the AICPA will soon issue the revised Audit and Accounting Guide for state and local governments for the effect of GASB Statement No. 34 and related pronouncements, it also will retain and continue to conform the 1994 Guide (Non-GASB 34 Edition) as needed until the final effective date of GASB Statement No. 34. The 1994 Guide (updated for conforming changes) remains effective for audits of state and local governments for which the auditor is not required to apply or has not elected to early apply the provisions of the revised Guide in accordance with its effective date provisions.

Help Desk—The product number for the 1994 Guide (Non-GASB 34 Edition) with conforming changes through May 1, 2002, is 012562kk. The section entitled “References for Additional Guidance” at the end of this Alert provides instructions for ordering AICPA products.

Revision of Audit and Accounting Guides for GASB Statement No. 34

Audits of State and Local Governments

The AICPA will soon issue the new Audit and Accounting Guide *Audits of State and Local Governments* (GASB 34 Edition). The new Guide addresses the audits of basic financial statements and consideration of required supplementary information (RSI) and supplementary information other than RSI (SI) prepared in conformity with the new governmental financial reporting model required by GASB Statement No. 34 and its related pronouncements. The new

Guide does not establish new “category b” GAAP.⁶ It has been cleared by the AICPA’s Accounting Standards Executive Committee (AcSEC) and ASB as well as by the GASB and presently is in production. The following information was taken from a draft of the new Guide and was still subject to change when we wrote this Alert.

Help Desk—The AICPA plans to release selected portions of the new Guide on its Web site, including illustrative auditor’s reports, as soon as available.

Effective Date. The new Guide is expected to be effective for audits of a state or local government’s financial statements for the first fiscal period ending after June 15, 2003, in which the government does apply or is required to apply the provisions of GASB Statements No. 34 or No. 35, *Basic Financial Statements—and Management’s Discussion and Analysis—for Public Colleges and Universities*.⁷ (The effective date provisions of GASB Statements No. 34 and No. 35 are discussed in the later section of this Alert entitled “GASB Pronouncements, Exposure Drafts, and Additional Projects.”) Earlier application will be encouraged if a government issues financial statements that apply GASB Statements No. 34 or No. 35 after the Guide is issued. The AICPA’s 1994 Audit and Accounting Guide *Audits of State and Local Governmental Units* (Non-GASB 34 Edition) (updated annually for conforming changes) will remain effective for audits of state and local governments for which the auditor is not required to apply or has not elected to early apply the provisions of the new Guide in accordance with its effective date provisions.

Scope. The new Guide, like the previous Guide, applies to all state and local governmental entities. That scope requires an auditor to consult two guides when performing audits of governmental enti-

6. See the discussion of the hierarchy of generally accepted accounting principles (GAAP) for state and local governmental entities in SAS No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles* (AICPA, *Professional Standards*, vol. 1, AU sec. 411), as amended.

7. Governmental Accounting Standards Board (GASB) Statement No. 35, *Basic Financial Statements—and Management’s Discussion and Analysis—for Public Colleges and Universities*, amends GASB Statement No. 34, *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments*, to include public colleges and universities within its scope.

ties in certain industries. Specifically, the new Guide applies to public entity risk pools and hospitals and other health care providers, even though the audits of those entities also are subject to the guidance in the Audit and Accounting Guides *Audits of Property and Liability Insurance Companies and Health Care Organizations*, respectively. The new Guide explains how auditors of those entities should use the auditing guidance in both of the guides that apply to those entities. The new Guide also provides an expanded section on auditing public colleges and universities. Specific auditing guidance for colleges and universities previously was provided in the AICPA Audit Guide *Audits of Colleges and Universities*, but the auditing guidance in that Guide was superseded by the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*.⁸

Materiality Determinations. The most significant issue addressed in the new Guide is materiality determinations for purposes of planning, performing, evaluating the results of, and reporting on the audit of financial statements.⁹ The nature of the governmental financial reporting model—with its focus on reporting separate financial statements or information for the governmental activities, the business-type activities, and each major governmental and enterprise fund—is the basis for how materiality is determined in an audit of governmental financial statements. The following is part of the discussion about materiality determinations that is expected to be in the new Guide.

As stated in SAS No. 47, your consideration of materiality is a matter of professional judgment and is influenced by your perceptions of the needs of a reasonable person who will rely on the financial statements. Because of the unique nature of governmental financial re-

8. Some of the accounting and financial reporting guidance in the AICPA Audit Guide *Audits of Colleges and Universities* applies to public colleges and universities that follow the AICPA College Guide model using the provisions of GASB Statement No. 15, *Governmental College and University Accounting and Financial Reporting Models*. That guidance continues to apply to such public colleges and universities that are not required to apply and have not elected to early apply the provisions of GASB Statement No. 35.

9. The GASB staff's *Guide to Implementation of GASB Statement No. 34 and Related Pronouncements: Questions and Answers* (2nd GASB 34 Q&A), as discussed in the later section of this Alert entitled "GASB Statement No. 34 Implementation Guidance," addresses how preparers should view the basic financial statements prepared in conformity with the provisions of GASB Statement No. 34 in applying materiality determinations.

porting, your consideration of whether a government's basic financial statements are presented fairly, in all material respects, in conformity with GAAP, should be based on *opinion units*, a new term and concept originating in the new Guide, as shown in Exhibit 1.

You should make separate materiality determinations for purposes of planning, performing, evaluating the results of, and reporting on the audit of a government's basic financial statements for each opinion unit. Except as discussed in the third following paragraph, the opinion units in a government's basic financial statements are (as applicable) the governmental activities; the business-type activities; the aggregate discretely presented component units; each major governmental and enterprise fund; and the aggregate remaining fund information (nonmajor governmental and enterprise funds, the internal service fund type, and the fiduciary fund types). You should view the financial statement reconciliations presented at the bottom of the fund financial statements or in an accompanying schedule as relating to presentation of the governmental activities and business-type activities opinion units.

Audit materiality is based on the opinion units indicated in Exhibit 1 because, as established in GASB Statement No. 34 and explained in the 2nd GASB 34 Q&A, a government's basic financial statements highlight a primary government's governmental activities, its business-type activities, and each of its major governmental and enterprise funds. As a general rule, the other information presented in a government's basic financial statements is separated into two opinion units—the aggregate remaining fund information and the aggregate discretely presented component units—because those groupings distinguish financial information for the primary government from financial information for its discretely presented component units.

You should make materiality evaluations for each opinion unit separately. That is, the materiality evaluation for one opinion unit should not be affected by other information in the government's financial statements or by quantitative or qualitative factors relating to other opinion units. In the audit of a government's basic financial statements, you should not establish more than one opinion unit for the aggregate remaining fund information. Similarly, you

Financial Statements	Basic Financial Statements									
	Government-wide Financial Statements							Fund Financial Statements		
Fund Categories										
Reporting Units (1)										
Opinion Units (3)										

- 64

should not establish more than one opinion unit for the aggregate discretely presented component units, regardless of how major component units are reported in the basic financial statements. However, because of the various, potentially diverse information comprising the aggregate opinion units, you should consider how qualitative and quantitative factors relating to the components of each aggregate unit will affect the nature, timing, and extent of audit procedures on that unit. Further, you may be engaged to set the scope of the audit and assess materiality at a more detailed level than by the opinion units required for the basic financial statements (for example, at an individual fund or fund type level). You would satisfy that engagement requirement by expanding the scope of your audit of the financial statements.

Normally, the aggregate discretely presented component units and the aggregate remaining fund information are treated as separate opinion units. In some cases, however, either the aggregate remaining fund information opinion unit or the aggregate discretely presented component unit opinion unit, or both, is not quantitatively or qualitatively material to the primary government. In those situations, you may choose to combine the two aggregate opinion units into a single opinion unit that is referred to as the “aggregate discretely presented component unit and remaining fund information” opinion unit. Even if that combined aggregate opinion unit is not material to the primary government, no further aggregation of that opinion unit with other of the government’s opinion units is permitted. Similarly, no further aggregation is permitted if the government has only one of the aggregate opinion units and that opinion unit is not material to the primary government.

You should determine opinion units for audits of a special-purpose government’s basic financial statements in the same manner as for general-purpose governments. For example:

- A government that is engaged only in business-type activities may have more than one opinion unit. For example, a utility district with more than one enterprise fund (one each for its water, sewer, electric, and trash operations) will have an opinion unit for each major enterprise fund and another opinion unit for its aggregate nonmajor enterprise funds, if any.

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- A government that is engaged only in fiduciary activities has only one opinion unit that represents, in effect, “remaining fund information.” For a public employee retirement system (PERS) with more than one defined benefit pension plan that presents separate financial statements for each plan as required by GASB standards, those separate plan financial statements do not represent separate opinion units but rather are aggregated into a single opinion unit.
 - Notwithstanding the previous bullets, if a special-purpose government has one or more discretely presented component units, that component unit, or the aggregate of those component units, is an opinion unit separate from the government’s other opinion unit(s) unless the aggregate component units meet the conditions for combining with the aggregate remaining fund information as discussed previously.

You should plan the audit to obtain reasonable assurance of detecting misstatements that you believe could be large enough, individually or in the aggregate, to be quantitatively material to the financial presentation of an opinion unit. SAS No. 47, as amended (AICPA, *Professional Standards*, vol. 1, AU sec. 312.20), states that although you should be alert for misstatements that could be qualitatively material, it ordinarily is not practical for you to design procedures to detect them. SAS No. 47, as amended, and its Interpretations (AICPA, *Professional Standards*, vol. 1, AU sec. 9312) provide guidance in evaluating whether financial statements are fairly presented in all material respects in conformity with GAAP. In evaluating misstatements, you should not rely exclusively on quantitative benchmarks to determine whether an item is material to the financial presentation of an opinion unit. You also should consider qualitative aspects of misstatements. The new Guide lists some qualitative factors that could be considered in an audit of governmental financial statements.

Auditors’ Reports. The type of report the independent auditor issues depends primarily on the contents of the basic financial statements and on the scope and results of the audit. The new Guide discusses the auditor’s report on governmental financial statements

in various situations. Your primary responsibility is to report on the results of your audit of the basic financial statements. You have additional responsibilities related to RSI and SI.

The AICPA's fourth standard of reporting requires that the auditor's report contain either an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. In reporting on a government's basic financial statements, the auditor's report generally should contain either expressions of opinion regarding the financial statements for each opinion unit, or assertions to the effect that an opinion on one or more opinion units cannot be expressed. Generally, the auditor expresses or disclaims an opinion on a government's financial statements taken as a whole by providing opinions or disclaimers of opinion on each opinion unit.

Your evaluation of the results of audit procedures that would lead to an opinion modification on one opinion unit may or may not result in an opinion modification on another opinion unit. For example, a GAAP departure may result in an opinion modification on a major governmental fund opinion unit. You may conclude that the effect of that departure also has a material effect on the presentation of governmental activities and therefore also modify the opinion on the governmental activities opinion unit. On the other hand, you may conclude that the effect of that departure does not materially affect governmental activities, and not modify the opinion on the governmental activities opinion unit for the departure.

For the financial statements of special-purpose governments that are engaged only in business-type activities or that are engaged only in fiduciary activities that have a single opinion unit, you will give a single opinion. In those situations, your report should contain either an expression of opinion regarding the financial statements taken as a whole, or an assertion to the effect that an opinion on the financial statements taken as a whole cannot be expressed. For special-purpose governments that have more than one opinion unit (for example, special-purpose governments that are engaged only in business-type activities that have more than one enterprise fund), your report generally will provide more than one opinion.

For entities with more than one opinion unit, certain egregious situations will result in you expressing an adverse opinion or disclaimer of opinion on the financial statements taken as a whole. It is appropriate to express an adverse opinion on the financial statements taken as a whole when the required government-wide or fund financial statements are not presented. It also is appropriate to express an adverse opinion or disclaimer of opinion on the financial statements taken as a whole when adverse opinions or disclaimers of opinion are appropriate for both the governmental activities and business-type activities opinion units (or for only the governmental activities opinion unit if that is the only required presentation for the primary government in the reporting entity's government-wide financial statements). In other situations in which adverse opinions or disclaimers of opinion on one or more opinion units are appropriate, you should use professional judgment to evaluate the facts and circumstances of those opinion modifications to determine whether the financial statement presentations on which you are considering issuing a modified report are of such a nature that the financial statements, taken as a whole, are not presented fairly in conformity with GAAP or it is appropriate to disclaim an opinion on the financial statements taken as a whole.

Following is the draft standard report on a typical government's basic financial statements showing unqualified opinions on a single year's basic financial statements that contain more than one opinion unit, with reporting on accompanying RSI and SI. (Note that different situations will require different reporting, including different reporting on RSI and SI.)

Independent Auditor's Report

We have audited the accompanying financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of and for the year ended June 30, 20X1, which collectively comprise the City's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the City of Example's management. Our re-

sponsibility is to express opinions on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position and cash flows, where applicable, thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The [*identify accompanying required supplementary information, such as management's discussion and analysis and budgetary comparison information*] on pages XX through XX and XX through XX are not a required part of the basic financial statements but are supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the City of Example's basic financial statements. The [*identify accompanying supplementary information, such as the introductory section, combining and individual nonmajor fund financial statements, and statistical tables*] are presented for purposes of additional analysis and are not a required part of the basic financial statements. The

[*identify relevant supplementary information, such as the combining and individual nonmajor fund financial statements*] have been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole. The [*identify relevant supplementary information, such as the introductory section and statistical tables*] have not been subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we express no opinion on them.

[Signature]

[Date]

The new Guide also discusses departures from the standard report and special situations such as the part of the audit performed by another auditor and prior-period financial information. It also illustrates auditors' reports on basic financial statements for situations such as:

- A special-purpose government that has a single opinion unit
- One but not all discretely presented component units are not audited
- GAAP departures in some of the major governmental funds
- GAAP departures in governmental activities
- All component units are omitted (primary government-only presentation)
- An audit engagement that requires the auditor to set the scope of the audit and assess materiality at a more detailed level than by opinion unit

Other Discussions in the New Guide. The new Guide includes numerous other discussions and illustrative auditors' reports relevant to the audit of a government's financial statements, including:

- Auditor procedures and reporting on SI and RSI
- Auditor reporting on individual fund financial statements; departmental, agency, and program financial statements; spe-

cial-purpose regulatory presentations as provided for in SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623.22-.26); and summary financial information.

The new Guide discusses how GASB Statement No. 34 affects financial statements prepared in conformity with a comprehensive basis of accounting other than GAAP (other comprehensive basis of accounting [OCBOA] financial statements). Specifically, it states that OCBOA financial statements should include government-wide financial statements and columnar presentations of major funds. The new Guide also provides an illustrative auditor's report on OCBOA financial statements.

The new Guide presents various issues relating to the transition to the provisions of GASB Statement No. 34. For example, it discusses how, if a component unit does not implement GASB Statement No. 34 when it is required to do so, you should consider the effect of that departure from GAAP on the report on the component unit's financial statements. Opinion modifications on a component unit's financial statements also may result in opinion modifications on the reporting entity financial statements.

The new Guide also discusses auditor association with municipal securities filings. See the highlights of that guidance in the earlier section of this Alert entitled "Securities and Exchange Commission and Municipal Securities Developments."

Audits of Property and Liability Insurance Companies and Health Care Organizations

The state and local government guide is not the only industry-specific AICPA Audit and Accounting Guide that auditors might have to consider when performing an audit of a governmental entity. Two other industry-specific guides—*Audits of Property and Liability Insurance Companies* and *Health Care Organizations*—include certain governmental entities in their scope and were cleared by the GASB. Therefore, certain accounting and financial reporting guidance in those guides constitutes "category b" GAAP for the applicable governmental entities, and the auditing guidance in those guides also should be considered during an audit of those governmental entities. (See also the discussion of SAS No. 95 in the ear-

lier section of this Alert entitled “Recent Auditing Standards and Other Guidance.”) AICPA staff will include conforming changes for the effects of GASB Statement No. 34 and related pronouncements in the 2002 editions of those guides.

Effect of Adopting GASB Statement No. 34 on Auditors’ Reports

The adoption of GASB Statement No. 34 constitutes a change in accounting principles that, unless immaterial, will require the auditor’s report to include an explanatory paragraph regarding consistency. Such a paragraph could read “As described in Note X, the City has implemented a new financial reporting model as required by the provisions of GASB Statement No. 34, *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments*, as of June 30, 20X1.”

Ethics Interpretation 101-10

Ethics Interpretation 101-10, “The Effect on Independence of Relationships With Entities Included in the Governmental Financial Statements,” of the AICPA Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2, ET sec. 101.12), discusses the effect on an auditor’s independence of relationships with entities included in governmental financial statements. The AICPA plans to issue an ED of a proposed Interpretation in 2002 to revise that guidance for, among other things, the changes in financial statement presentation resulting from GASB Statement No. 34. In auditing governmental financial statements prepared in conformity with GASB Statement No. 34, you should use professional judgment and the concepts expressed in Interpretation 101-10 to evaluate independence in relation to a primary government, parts of the primary government, component units, and other organizations disclosed in the reporting entity’s financial statements until the Interpretation is revised.

Information Systems Security Auditing Guidance

In December 2001, the National State Auditors Association (NSAA) and the GAO jointly issued *Management Planning Guide for Information Systems Security Auditing*. The guide is in-

tended to aid governmental audit organizations in responding to the risks attributable to the pervasive and dynamic effects of the expanding use of information technology by governments. Also, the guide is intended to be pertinent to any governmental audit organization, regardless of its size and current methodology. Directed primarily at senior and executive audit management, the guide leads the reader through the steps for establishing or enhancing an information security auditing capability. These include planning, developing a strategy, implementing the capability, and assessing results.

Help Desk—The guide is available on the GAO Web site at www.gao.gov/special.pubs/mgmtpln.pdf and the National Association of State Auditors, Comptrollers, and Treasurers Web site at www.nasact.org/techupdates/gao.cfm.

Common Engagement Deficiencies

Following are some deficiencies commonly noted on governmental engagements during recent peer reviews and AICPA Professional Ethics Division investigations of CPA firms, beside those already discussed in the earlier section of this Alert entitled “Circular A-133 Audit Guidance Update.” This list continues to include some of the deficiencies identified in past Alerts, indicating continuing problems with the same matters. You should consider reviewing your firm’s policies and procedures to see whether your governmental engagements also might have these kinds of issues.

- The auditor used inadequate or outdated reference material related to the engagement performed.
- GAAP requirements for the classification, accounting, and reporting for particular funds and for disclosures were not followed.
- *Government Auditing Standards*’ continuing professional education and audit documentation requirements were not met.
- The required *Government Auditing Standards* reports for internal control or compliance were not prepared or were not referred to in the report on the financial statements.

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- The engagement letter did not include proper references to Circular A-133 requirements or record retention policies, or include a copy of the latest peer review report.
 - The audit program did not address all applicable Circular A-133 requirements.
 - Audit documentation did not make it clear that major programs were properly identified (see Circular A-133, section .520, and the major programs refresher in Appendix A).
 - The required compliance testing was not performed, sometimes because the auditor did not follow the guidance in Part 7 of the *Compliance Supplement* for identifying the applicable compliance requirements to test and report on.
 - Internal control and compliance tests were not adequately designed or documented to support the reports issued.
 - The management representation letter did not follow the requirements of SAS No. 85, *Management Representations*, as amended (AICPA, *Professional Standards*, vol. 1, AU sec. 333), or include the additional representations required by SOP 98-3 for a Circular A-133 audit.
 - The appropriate Circular A-133 reports were not included.
 - The schedule of expenditures of federal awards was not presented or reported upon.
 - The auditor did not appropriately follow the HUD audit guide.

Governmental Employee Benefit Plan Guidance

Starting with the 2001 edition, the Audit Risk Alert *Employee Benefit Plans Industry Developments* includes a section to address audit, accounting, and regulatory issues unique or significant to public employee retirement systems (PERSs) and other governmental employee benefit plans. The AICPA has placed that information in that Alert—a complement to the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, which does not apply to governmental entities—because many auditors of PERSs and other

governmental employee benefit plans consult that Alert when planning their audits.

Help Desk—The product number for the Audit Risk Alert *Employee Benefit Plans Industry Developments—2002* is 022287kk. The section entitled “References for Additional Guidance” at the end of this Alert provides instructions for ordering AICPA products.

Accounting Issues and Developments

GASB Pronouncements, Exposure Drafts, and Additional Projects

GASB Pronouncements on the New Financial Reporting Model

The GASB has issued five pronouncements on the new financial reporting model in the past several years that start to become effective in 2002. While many governments are not required to apply those standards in 2002, the GASB encourages early application. You should determine which standards are effective for the governments you audit or which standards they are applying early. You should consult the original pronouncements for a complete understanding of their provisions.

GASB Statement No. 34, as Amended by GASB Statement No. 37, and GASB Statement No. 35. GASB Statement No. 34, *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments*, issued in June 1999, significantly changes the presentation of state and local government financial statements. In June 2001, the GASB issued Statement No. 37, *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments: Omnibus*, in part to clarify and modify certain provisions of GASB Statement No. 34. (See the discussion of GASB Statement No. 37 later in this section.)

Given the significance of GASB Statement No. 34, you should consider starting to work with the governments you audit to prepare for implementation, which may in some cases take considerable effort. GASB Statement No. 34 includes nonauthoritative illustrations of the basic financial statements and supplementary information it requires. See also the sections of this Audit Risk

Alert entitled “Revision of Audit and Accounting Guides for GASB Statement No. 34” and “GASB Statement No. 34 Implementation Guidance.”

GASB Statement No. 34 initially applied to all state and local governments except public colleges and universities. However, GASB Statement No. 35, *Basic Financial Statements—and Management’s Discussion and Analysis—for Public Colleges and Universities*, which was issued in November 1999, extended the applicability of GASB Statement No. 34 to those entities.

GASB Statement No. 34’s effective dates are based on the total annual revenues of a government’s governmental and enterprise funds (excluding other financing sources and extraordinary items),¹⁰ measured in the first fiscal year ending after June 15, 1999, as follows. Earlier application is encouraged.

<i>Phase</i>	<i>Total Annual Revenues in the First Fiscal Year Ending After June 15, 1999 (in millions)</i>	<i>Implementation Required for Periods Beginning After June 15,—</i>
1	\$100 or more	2001
2	\$10 to \$100	2002
3	Less than \$10	2003

Each component unit is required to implement the Statement no later than the same year as its primary government, even if that is earlier than its “assigned” phase based on the component unit’s revenues in the first fiscal year ending after June 15, 1999. If a primary government chooses to implement GASB Statement No. 34 earlier than required, all of its component units also are required to implement the Statement early. GASB Statement No. 34 has special transition provisions relating to the retroactive reporting of general infrastructure assets.

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10. Certain entities should use measures other than total annual revenues to determine the appropriate implementation phase. For example, special-purpose governments engaged only in fiduciary activities should use total annual additions, rather than revenues. Further, a public college or university’s implementation phase is based on its revenues excluding additions to investment in plant or other financing sources and extraordinary items.

Contents of Governmental Financial Statements. GASB Statement No. 34 requires a general-purpose government to present basic financial statements that include government-wide financial statements, fund financial statements, and notes to the financial statements. The basic financial statements for certain special-purpose entities do not include government-wide financial statements. For all governments, the basic financial statements should be accompanied by relevant RSI, including a management's discussion and analysis (MD&A), to provide an analytical overview of financial activities. GASB Statement No. 34, paragraph 11, as amended, indicates the topics to which the MD&A should be confined. The Statement also requires certain RSI for budgetary information and infrastructure assets reported using the modified approach.

Basic Financial Statements. The basic financial statements replace a government's current general-purpose financial statements (GPFS).

- *Government-wide financial statements.* There are two government-wide financial statements—a statement of net assets and a statement of activities—prepared using the economic resources measurement focus and the accrual basis of accounting. The statements distinguish between the governmental and business-type activities of the primary government and between the total primary government and its discretely presented component units. The statement of net assets generally reports all capital assets, including infrastructure assets, and the statement of activities generally reports depreciation expense on capital assets except eligible infrastructure assets for which the government adopts the modified approach. The statement of net assets reports three categories of net assets—invested in capital assets net of related debt, restricted, and unrestricted. The statement of activities is presented in a format that reports, for each function, expenses reduced by program revenues, followed by general revenues (such as taxes), contributions to permanent and term endowments, contributions to permanent fund principal, special items, and extraordinary items.
- *Fund financial statements.* Fund financial statements consist of a series of statements for each of the three categories

of funds—governmental, proprietary, and fiduciary. Major governmental and enterprise funds are reported in separate columns in the governmental and proprietary fund financial statements. Governmental and proprietary fund financial statements include summary reconciliations to the government-wide financial statements, if applicable, at the bottom of the statements or in accompanying schedules.

- *Notes to the financial statements.* GASB Statement No. 34 continues previous disclosure standards, and adds requirements for certain other disclosures directly related to the provisions of the Statement. (See also the discussion below of GASB Statement No. 38, *Certain Financial Statement Note Disclosures*.)

Help Desk—In the fall of 2001, the AICPA updated its Practice Aid *Understanding and Implementing GASB's New Financial Reporting Model: A Question and Answer Guide for Preparers and Auditors of State and Local Governmental Financial Statements* to help you and the governments you audit understand the new standards. See the discussion in the later section of this Alert entitled “GASB Statement No. 34 Implementation Guidance.”

GASB Statement No. 37. The GASB issued Statement No. 37, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Omnibus*, in June 2001 to amend GASB Statement No. 21, *Accounting for Escheat Property*, and to clarify or modify certain provisions of GASB Statement No. 34.

GASB Statement No. 37 amends GASB Statement No. 21 to explain the effect of the changes to the fiduciary fund structure required by GASB Statement No. 34 on the reporting of escheat property. Generally, escheat property that was reported in an expendable trust fund in the previous model should be reported in a private-purpose trust fund under Statement No. 34.

GASB Statement No. 37 clarifies certain provisions of GASB Statement No. 34, including the following:

- The contents of MD&A should be confined to the topics specified in paragraph 11 of GASB Statement No. 34.

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- Adopting the modified approach for infrastructure assets that have previously been depreciated is considered a change in an accounting estimate and should be accounted for prospectively, rather than as a restatement of prior periods.
 - Fines and forfeitures should be included in the government-wide financial statements in the “charges for services” category. Also, “charges for services” should be classified in the function that generates the revenue; “grants” and “contributions” should be classified in the function to which the revenues are restricted.
 - Major fund reporting requirements apply to a governmental fund (other than the general or equivalent fund) or an enterprise fund if the same element (for example, revenues) exceeds both the 10 percent and 5 percent criteria.
 - Notes to RSI need only disclose the excesses of expenditures over appropriations of the individual funds presented in the budgetary comparison.

GASB Statement No. 37 modifies certain provisions of GASB Statement No. 34, including the following:

- Eliminates the requirement in Statement No. 34, paragraph 18, to capitalize construction-period interest for governmental activities.
- Changes the requirement in Statement No. 34, paragraph 39, to report business-type activities in the statement of activities by segments to a requirement to report that detail by different identifiable activities.
- Redefines *segment* in Statement No. 34, paragraph 122, for purposes of note disclosure.

GASB Statement No. 37 requires that its provisions be simultaneously implemented with GASB Statement No. 34. (See the discussion of GASB Statement No. 34’s effective dates earlier in this section.) For governments that implemented Statement No. 34 before Statement No. 37 was issued, Statement No. 37 is effective for financial statements for periods beginning after June 15, 2000.

GASB Statement No. 38. In GASB Statement No. 38, *Certain Financial Statement Note Disclosures*, the GASB reconsidered disclosure requirements that have been effective since 1994, except for disclosures that it will reexamine in its other projects. Statement No. 38, issued in June 2001, rescinds the requirement in NCGA Statement 1, *Governmental Accounting and Financial Reporting Principles*, paragraph 92, to disclose the accounting policy for encumbrances and removes general budget policies from the sequence of suggested disclosures in the appendix of NCGA Interpretation 6. GASB Statement No. 38 also requires the following new or modified disclosures in the notes to the financial statements:

1. For governments that present their basic financial statements in more than a single column, descriptions of the activities accounted for in the major funds, internal service funds, and fiduciary fund types.
2. The length of time used to define *available* for purposes of recognizing revenue in governmental fund financial statements.
3. Actions taken to address significant violations of finance-related legal or contractual provisions.
4. For debt obligations, principal and interest requirements to maturity, presented separately, for each of the next five fiscal years and in five-year increments after that. (For variable-rate debt, interest requirements are determined using the rate in effect at the financial statement date and the terms by which interest rates change for that debt are disclosed.)
5. For capital and noncancelable operating leases, the future minimum payments for each of the next five fiscal years and in five-year increments after that.
6. A schedule of short-term debt activity during the year and a description of the purpose for which short-term debt was issued.
7. Details of receivables and payables when aggregation obscures the significant components of those accounts in the statements of net assets and balance sheets.

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8. Significant receivable balances not expected to be collected within one year of the financial statement date.
 9. For interfund balances reported in the fund financial statements:
 - a. The amounts due from other funds by individual major fund, nonmajor governmental funds in the aggregate, nonmajor enterprise funds in the aggregate, internal service funds in the aggregate, and fiduciary fund type,
 - b. A description of the purpose for interfund balances, and
 - c. Identification of interfund balances that are not expected to be repaid within one year of the financial statement date.
 10. For interfund transfers reported in the fund financial statements:
 - a. The amounts transferred from other funds by individual major fund, nonmajor governmental funds in the aggregate, nonmajor enterprise funds in the aggregate, internal service funds in the aggregate, and fiduciary fund type,
 - b. A general description of the principal purposes of the government's interfund transfers, and
 - c. A description of the intended purpose and the amount of significant transfers that (i) do not occur on a routine basis (such as a transfer to a wastewater enterprise fund for the local match of a federal pollution control grant) or (ii) are inconsistent with the activities of the fund making the transfer (for example, a transfer from a capital projects fund to the general fund).

GASB Statement No. 38 clarifies that note disclosures are only required when the required information is not displayed on the face of the financial statements. It also provides nonauthoritative illustrative disclosures in an appendix.

The effective date of GASB Statement No. 38 coincides with the effective date of GASB Statement No. 34 for individual governments (see the discussion earlier in this section). However, phase

1 governments can delay the disclosures listed in 6–10 above for one additional year. In addition, earlier application of the disclosures (except those in 1, 9, and 10 above) is encouraged, even though Statement No. 34 is not yet applied.

GASB Interpretation No. 6. In March 2000, the GASB issued GASB Interpretation No. 6, *Recognition and Measurement of Certain Liabilities and Expenditures in Governmental Fund Financial Statements*. The effective date of the Interpretation coincides with the effective date of GASB Statement No. 34 for individual governments (see the discussion earlier in this section). Earlier application is encouraged provided that the Interpretation and GASB Statement No. 34 are implemented simultaneously.

GASB Interpretation No. 6 provides the following guidance about the application of modified accrual standards in governmental fund financial statements:

- Unless there is an applicable accrual modification, governmental fund liabilities and expenditures should be accrued.
- A government's unmatured long-term indebtedness (other than "specific fund debt" of proprietary and trust funds) should be reported as general long-term liabilities, rather than as governmental fund liabilities.
- A government may accrue an additional governmental fund liability and expenditure for debt service on general long-term debt, beyond the amounts matured, if it has "provided" financial resources to a debt service fund for payment of liabilities that will mature early in the following year.
- Liabilities for compensated absences, claims and judgments, special termination benefits, and landfill closure and postclosure care costs are "normally expected to be liquidated with expendable available financial resources," and should be recognized as governmental fund liabilities, to the extent that they mature each period. The accumulation of financial resources in a governmental fund for eventual payment of unmatured liabilities (for example, compensated absences expected to become due in future periods)

does not result in the recognition of an additional governmental fund liability or expenditure.

GASB Statement No. 39

In May 2002, the GASB issued its Statement No. 39, *Determining Whether Certain Organizations Are Component Units—An Amendment of GASB Statement No. 14*, which is effective for financial statements for periods beginning after June 15, 2003. Earlier application is encouraged. GASB Statement No. 39 amends GASB Statement No. 14 to provide additional guidance to determine whether certain organizations for which the primary government is not financially accountable should be reported as component units based on the nature and significance of their relationship with the primary government. Entities that are legally separate, tax-exempt organizations and that meet *all* of the following should be discretely presented as component units.

1. The economic resources received or held by the separate organization are entirely or almost entirely for the direct benefit of the primary government, its component units, or its constituents.
2. The primary government, or its component units, is entitled to, or has the ability to otherwise access, a majority of the economic resources received or held by the separate organization.
3. The economic resources received or held by an individual organization that the specific primary government, or its component units, is entitled to, or has the ability to otherwise access, are significant to that primary government.

GASB Statement No. 14 continues to require professional judgment to determine whether the relationship between a primary government and other organizations for which the primary government is not financially accountable, and that do not meet the criteria in GASB Statement No. 39, is such that excluding the organization would make the reporting entity's financial statements misleading or incomplete. Those other organizations should be reported as component units based on the existing blending and discrete presentation display requirements of GASB Statement No. 14.

Additional GASB Projects

Although the GASB has continued to devote significant efforts to the implementation of the new financial reporting model, it has numerous other short- and long-term projects on its agenda. Projects that may see EDs of proposed accounting and financial reporting standards released in 2002 and 2003 include disclosures about deposit and investment risks, other postemployment benefits, environmental liabilities, capital asset impairment, and certain economic condition reporting issues (primarily relating to statistical information).

The GASB also has identified several financial reporting issues as potential long-term and research projects: (1) fiduciary responsibilities; (2) financial instruments; (3) the financial section of the comprehensive annual financial report (CAFR); (4) additional economic condition reporting issues; (5) popular reporting; (6) service efforts and accomplishments (performance measurement); (7) electronic financial reporting; and (8) the preservation method for infrastructure assets.

Help Desk—If you are interested in tracking the progress of the GASB's projects, information is posted on the GASB Web site at www.gasb.org.

The GASB also continues to support governments' experimentation in the use and reporting of performance measures through its Web site for performance measurement for government at www.seagov.org. That Web site has a wealth of resources that include discussions of the nature and purpose of performance measures in governments and the GASB's research on the topic, links to performance measurement and management-related resources on the Internet, and contact information for persons involved in performance measurements for governments.

GASB Statement No. 33 *Implementation Issue*

GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, as amended by GASB Statement No. 36, *Recipient Reporting for Certain Shared Nonexchange Revenues*, was effective for financial statements for periods beginning after June 15, 2000. The Statement, as amended, provides accounting and fi-

nancial reporting standards for nonexchange transactions involving financial or capital resources. In a nonexchange transaction, a government gives (or receives) value without directly receiving (or giving) equal value in return. The principal issue addressed in Statement No. 33, as amended, is the timing of recognition of nonexchange transactions. (A full description of the provisions of GASB Statements No. 33 and No. 36 is in last year's Alert.)

While applying GASB Statement No. 33, as amended, to grants reported in governmental funds, some governments have questioned why revenue for grants with purpose restrictions is not necessarily recognized in the same period as the related expenditures, as it was in the past. Practice in applying the previous standards resulted in revenue for such grants often being recognized when the expenditures were made. Many referred to those grants as "expenditure driven grants." However, GASB Statement No. 33 narrowed the understanding of expenditure-driven grants by indicating that unless reimbursement is an eligibility requirement, revenue for grants with purpose restrictions is not expenditure-driven. Under GASB Statement No. 33, grant revenue generally is recognized in governmental funds when all applicable eligibility requirements are met and the amounts are "available." If a grantor does not offer a purpose-restricted grant on a reimbursement basis, revenue recognition is not delayed until the grant recipient has incurred allowable costs. Instead, the revenue is recognized based on the grant's eligibility requirements, if any, and the availability of the amounts. If the purpose restriction is not satisfied in the same period revenue is recognized, the resulting governmental fund balance is reported as reserved.

GASB Statement No. 34 *Implementation Guidance*

Since the release of the GASB 34 Q&A in April 2000, a substantial number of new implementation questions were raised. Consequently, in December 2001, the GASB staff issued another question-and-answer book, *Guide to Implementation of GASB Statement 34 and Related Pronouncements* (2nd GASB 34 Q&A). The 2nd GASB 34 Q&A includes more than 170 questions and answers about the new financial reporting model and related note disclosures as well as GASB Statement No. 33, as amended. It also includes illustrative fi-

nancial statements for a county government. Among the questions and answers is a discussion of materiality determinations for purposes of preparing the basic financial statements in conformity with the provisions of GASB Statement No. 34.

The AICPA has issued a revised edition of its question-and-answer booklet on GASB Statement No. 34. *Understanding and Implementing GASB's New Financial Reporting Model: A Question and Answer Guide for Preparers and Auditors of State and Local Governmental Financial Statements, Revised Edition* (product no. 022516kk), updates the original publication to include the effects of GASB Statements No. 37 and 38, GASB Interpretation No. 6, and the GASB 34 Q&A. The booklet provides a complete, yet uncomplicated, explanation of the standards for the new financial reporting model. It includes more than 60 questions and answers that digest the contents of the standards, refers you to relevant paragraphs in the GASB pronouncements and the GASB 34 Q&A, analyzes the standards, and identifies issues auditors and preparers should consider in the implementation planning process. The booklet is a useful reference tool that can be easily distributed to staff and to the governments you audit, and could serve as a basis for training on the new standards. In addition, the AICPA has several group-study and self-study courses on GASB Statement No. 34. (The section at the end of this Alert entitled "References for Additional Guidance" provides instructions for ordering AICPA products and lists AICPA courses on governmental topics.)

Many other organizations, including the Association of School Business Officials International (ASBO), the Government Finance Officers Association (GFOA), the National Association of College and University Business Officers (NACUBO), the National Association of State Auditors, Comptrollers, and Treasurers (NASACT), and the Native American Finance Officers Association (NAFOA), also are providing written materials and training programs, or both, to help you understand GASB Statement No. 34 and related pronouncements and to find answers to implementation questions.

The GASB Web site has an area devoted to GASB Statement No. 34 implementation. That area includes a basic overview of and background information about GASB Statement No. 34, a calen-

dar of upcoming training sessions, a bibliography of implementation-related articles, links to Internet sites with information about implementation, and a list of question-and-answer databases and discussion forums. The site also lists governments that already have implemented the Statement, with links to electronic versions of many of their financial statements.

Help Desk—You should be cautious about discarding publications relating to the pre-GASB Statement No. 34 financial reporting models until you are certain that you will no longer need them, because they may go out of print.

FASB Statement No. 145

The FASB issued its Statement No. 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections*, in April 2002. FASB Statement No. 145 only affects governmental entities that apply the provisions of GASB Statement No. 20, paragraph 7, as amended. That GASB standard permits a government to apply all post-November 30, 1989, FASB pronouncements that do not conflict with or contradict GASB pronouncements to its proprietary funds and, when GASB Statement No. 34 becomes effective, to its enterprise funds and the resulting reporting of business-type activities in the government-wide financial statements. In particular, “paragraph 7” entities should note that FASB Statement No. 145 rescinds FASB Statements No. 4, *Reporting Gains and Losses from Extinguishment of Debt*, and No. 64, *Extinguishments of Debt Made to Satisfy Sinking-Fund Requirements*, thereby eliminating the requirement that gains and losses from debt extinguishments be classified as extraordinary items. Instead, those entities should use the provisions of Accounting Principles Board (APB) Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, as amended and interpreted, to report debt extinguishments in fiscal years beginning after May 15, 2002, with earlier application encouraged. Other effective dates apply to the other provisions of FASB Statement No. 145.

GASB Statements No. 20, paragraph 6, and No. 34, paragraphs 17 and 93, require all governments to apply the nonconflicting, noncontradictory provisions of FASB Statements and Interpretations, APB Opinions, and Accounting Research Bulletins (ARBs) of the Committee on Accounting Procedure issued on or before November 30, 1989, in their government-wide and proprietary fund financial statements. That is the case even if the FASB rescinds or amends a pre-1989 private-sector standard. Therefore, except in those situations in which a government has elected to apply all post-1989 FASB pronouncements, it should not apply the provisions of FASB Statement No. 145.

References for Additional Guidance

AICPA

Web Site

AICPA Online (www.aicpa.org) is the AICPA's Web site on the Internet. The site offers users the opportunity to stay abreast of developments in accounting and auditing. Online resources include professional news, membership information, state and federal legislative updates, AICPA press releases, speeches, EDs, and a list of links to other accounting- and finance-related sites. The AICPA Web site also features a "Talk to Us" section, allowing users to send e-mail messages directly to AICPA representatives or teams. The AICPA Web site includes a separate section that deals with Circular A-133 audit issues, including a document that provides unofficial answers to frequently asked questions, at www.aicpa.org/belt/a133main.htm.

Order Department (Customer Service Center)

To order AICPA products, call the AICPA/CPA2Biz Customer Service Center at (888) 777-7077 or fax to (800) 362-5066. The best times to call are 8:30 a.m. to 11:30 a.m. and 2:00 p.m. to 7:30 p.m., Eastern Standard Time. Also, visit the CPA2Biz Web site at www.cpa2biz.com to obtain product information and place online orders.

Publications

The following AICPA publications may be of interest to auditors of state and local governments.

- Audit and Accounting Guide *Audits of State and Local Governmental Units* (Non-GASB 34 Edition) (product no. 012562kk)
- Audit and Accounting Guide *Audits of State and Local Governments* (GASB 34 Edition), to be issued in 2002 (product no. 012662kk)
- Audit and Accounting Guide *Health Care Organizations* (product no. 012612kk)
- Audit and Accounting Guide *Audits of Property and Liability Insurance Companies* (product no. 012672kk)
- SOP 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising* (product no. 014887kk)—This SOP is an appendix to the two Audit and Accounting Guides for state and local governments (see previous bullets) and the Audit and Accounting Guide *Not-for-Profit Organizations* (product no. 012642kk). It also is included in *AICPA Technical Practice Aids* (product no. 005141kk).
- SOP 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*—This SOP is an appendix to the Audit and Accounting Guides for state and local governments and not-for-profit organizations and in *Technical Practice Aids* (see bullets above).
- Understanding and Implementing *GASB's New Financial Reporting Model: A Question and Answer Guide for Preparers and Auditors of State and Local Governmental Financial Statements, Revised Edition* (product no. 022516kk)—This revised publication provides a summary of the significant portions of GASB Statement No. 34 and related GASB publications. For a detailed description, see the earlier section of

this Alert entitled “GASB Statement No. 34 Implementation Guidance.”

- *Auditing Recipients of Federal Awards: Practical Guidance for Applying OMB Circular A-133*, Audits of States, Local Governments, and Non-Profit Organizations, *Second Edition* (product no. 006607kk)—This Practice Aid contains comprehensive analyses and guidance on applying OMB Circular A-133. The publication includes numerous audit checklists and illustrative examples to help auditors perform audits that comply with regulations.
- *Checklists and Illustrative Financial Statements for State and Local Governmental Units* (product no. 008788kk)—Updated annually, this publication provides checklists and illustrations of financial statements, note disclosures, and auditors’ reports, including reports in accordance with *Government Auditing Standards* and the Single Audit Act Amendments of 1996. A GASB 34 edition is expected to be issued in 2002.
- *Audit and Accounting Manual* (product no. 005132kk)—Updated annually, this publication has an extensive section of internal control questionnaires and audit programs for audits of governmental entities, including audits in accordance with the Single Audit Act Amendments of 1996.

Continuing Professional Education Courses

The AICPA offers continuing professional education (CPE) in the form of both group-study and self-study courses, and in print and video format.

Group-study courses include the following:

- Advanced Auditing of HUD-Assisted Projects
- Applying A-133 to Nonprofit and Governmental Organizations
- Applying Fraud SAS No. 82 in Governmental and Not-for-Profit Audits
- Auditing State and Local Governments

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- Audits of HUD-Assisted Projects
 - Audits of Public Schools
 - GASB No. 34 Auditing: The Home of the Brave
 - GASB No. 34 Implementation: From Here to There
 - GASB No. 34 Infrastructure: How in the GASB Are We Going To Do This?
 - Government Reporting Models for 2000 and Beyond (GASB 34)
 - Governmental Accounting and Auditing Update
 - Governmental and Nonprofit Annual Update
 - Performance Audits of Governmental Entities
 - Solving Complex Single Audit Issues for Government and Nonprofit Organizations
 - Workpaper Preparation Techniques for Government and Nonprofit Organizations
 - Yellow Book: *Government Auditing Standards*

Self-study courses include the following (product numbers appear in parentheses after the course titles):

- Advanced Auditing of HUD-Assisted Projects (730187kk)
- Applying A-133 to Nonprofit and Governmental Organizations (730197kk)
- Applying Fraud SAS No. 82 in Governmental and Not-for-Profit Audits (735137kk)
- Auditing State and Local Governments (730287kk)
- Audits of HUD-Assisted Projects (730292kk)
- Audits of Public Schools (730281kk)
- GASB No. 34 Auditing: The Home of the Brave (731330kk)

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- GASB No. 34 Implementation: From Here to There (731566kk)
 - GASB No. 34 Infrastructure: How in the GASB Are We Going to Do This? (731561kk)
 - Government Reporting Models for 2000 and Beyond (GASB 34) (735172kk)
 - Governmental Accounting and Auditing Update (736470kk)
 - Performance Audits of Governmental Entities (737057kk)
 - Solving Complex Single Audit Issues for Government and Nonprofit Organizations (734405kk)
 - Workpaper Preparation Techniques for Government and Nonprofit Organizations (732630kk)
 - The Revised Yellow Book: *Government Auditing Standards* (736110kk)

The AICPA also offers the following video courses (available product numbers appear in parentheses after the course titles):

- GASB No. 34 Auditing: The Home of the Brave
- Governmental Accounting and Auditing Update (186474kk)
- Federal Accounting, Reporting, and Auditing Update (181010kk)
- The Revised Yellow Book: *Government Auditing Standards* (187100kk)

Online CPE

CPA2Biz offers an online learning library, *AICPA InfoBytes*. An annual fee (\$95 for members and \$295 for nonmembers) provides unlimited access to hundreds of hours of online CPE in one- and two-hour segments. Governmental topics covered include the Yellow Book, Circular A-133 auditing, GASB Statement No. 34, HUD, industry updates, and other pertinent issues. You can register today at infobytes.aicpaservices.org.

Industry Conference and Training Program

The AICPA will hold its 19th annual National Governmental Accounting and Auditing Update Conference on August 26-27, 2002, in Washington, D.C., and again on September 24-25, 2002, in Denver, Colorado. This high-level conference is designed for practitioners; officials working in federal, state, or local governmental finance and accounting; and recipients of federal awards. It is the premier forum for the discussion of important governmental accounting and auditing developments. Participants will receive updates on current issues, practical advice, and timely guidance on recent developments from experts.

The AICPA also offers an annual training program called the National Governmental and Not-for-Profit Training Program. This year's program will be held on October 21-23, 2002, in Las Vegas, Nevada. It is designed for practitioners or accountants, auditors, and other staff in government who want in-depth, hands-on training in government accounting and auditing.

For more information about the conference or the training program, please contact the AICPA/CPA2Biz Customer Service Center as indicated above, including through the CPA2Biz Web site.

Accounting and Auditing Technical Hotline

The Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

Ethics Hotline

Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. Call (888) 777-7077.

Fax Hotline

The AICPA has a 24-hour fax system that enables interested persons to obtain information that includes, for example, current AICPA comment letters, conference brochures and registration forms, CPE information, AcSEC actions, and legislative news. To

access the hotline, dial (201) 938-3787 from a fax machine and follow the voice cues.

Governmental Accounting Standards Board

GASB publications can be obtained by calling the GASB Order Department at (800) 748-0659. Publications are also available by mail (P.O. Box 30784, Hartford, CT 06150, payment by check) or on the GASB's Web site at www.gasb.org.

The GASB offers the following publications and services:

- *Codification of Governmental Accounting and Financial Reporting Standards*. The 2001–2002 edition is as of June 30, 2001. An updated edition as of June 30 each year is issued in late summer. Beginning with the June 30, 2001 edition, the GASB is issuing two versions of the *Codification*—one incorporating GASB Statement No. 34 and related pronouncements for governments that will begin to implement the standards in 2001 and the other with those standards remaining in an appendix.
- *GASB Original Pronouncements*, as of June 30, 2001. An updated edition as of June 30 each year is issued in late summer. As with the *Codification*, the GASB is issuing two versions of *Original Pronouncements* beginning with the June 30, 2001 edition—one that indicates the effects of GASB Statement No. 34 and related pronouncements and the other without.
- *GASB Implementation Guides*. Implementation guides are authored by GASB staff to explain how to implement a particular GASB standard. They are written in question-and-answer format, organized based on the general topics in the standard. The GASB staff has issued eight guides, which are not part of the GASB's subscription service.
- *GASB User Guides*. The GASB has published a series of guides to assist different users of government financial statements to understand what information can be found in fi-

financial statements prepared using the provisions of GASB Statement No. 34.¹¹

- *GASB Web Site*—Information about the GASB can be found on its Web site, www.gasb.org. The site features a section on GASB Statement No. 34 with a calendar of training sessions and seminars and links to online resources about the Statement. The “What’s New?” section contains the latest news about the GASB and governmental accounting, as well as calendars of GASB meetings, speaking engagements, constituent events, outstanding due process documents, the current-period technical plan, and other frequently requested materials. Other items include “Facts about GASB”; summaries of all final GASB documents and ordering information; and a list of board members, staff, and advisory council members with their e-mail addresses.
- *Performance Measurement for Government Web Site*—The GASB’s other Web site, located at www.seagov.org, is a clearinghouse for information about the development, use, and reporting of performance measures for governments. The site’s main features include a citizens’ guide and links to government performance indicators, studies, reports, government sites, ongoing projects, and several online discussion groups.
- *Fax Information System*—The GASB has a 24-hour fax system that enables interested persons to obtain information on upcoming meetings, the current-period technical plan, and “Facts about GASB.” To access the system, dial (203) 847-0700, ext. 14, from a fax machine, and follow the voice cues.

Federal Agencies—Administrative Regulations

Most federal agencies issue general administrative regulations that apply to their programs and that provide general rules on how to

11. The GASB’s user guides are not authoritative pronouncements under the hierarchy of GAAP for governmental entities as provided in SAS No. 69, as amended.

apply for grants and contracts, how grants are made, the general conditions that apply to and the administrative responsibilities of grantees and contractors, and the compliance procedures used by the various agencies. Those regulations are included in the *Code of Federal Regulations*.

In 1988, a final rule, *Uniform Administrative Requirements for Grants and Cooperative Agreements with State and Local Governments*, was published, establishing a common rule to create consistency and uniformity among federal agencies in the administration of grants to and cooperative agreements with state, local, and federally recognized Indian tribal governments. The common rule has been codified in each federal agency's portion of the *Code of Federal Regulations*.

General Accounting Office

The GAO home page, on the Internet at www.gao.gov, contains links to the hundreds of reports and testimony to the Congress each year on a variety of subjects, including accounting, budgeting, and financial management. Hard copies of GAO reports and testimony can be obtained from the GAO, P.O. Box 37050, Washington, DC 20013; phone (202) 512-6000; fax (202) 512-6061; or www.gao.gov/cgi-bin/ordtab.pl.

GAO's Web site is updated daily and also includes Comptroller General decisions and legal opinions; GAO policy documents; and special publications. You may subscribe to GAO daily electronic alerts using the form at www.gao.gov/subtest/subscribe.html.

The following publications are available on the GAO Web site at www.gao.gov/govaud/ybk01.htm. The first three publications also are available through the Superintendent of Documents, U.S. Government Printing Office (GPO), P.O. Box 371954, Pittsburgh, PA 15250-7954; phone (202) 512-1800; fax (202) 512-2250; or bookstore.gpo.gov/index.html.

- *Government Auditing Standards, 1994 Revision*—These standards relate to financial and performance audits of governmental organizations, programs, activities, and func-

tions, and of governmental funds received by contractors, nonprofit organizations, and other nongovernmental organizations. (GPO Stock No. 020-000-00265-4) There also is a codification of the 1994 standards that includes the Government Auditing Standards Amendments on the GAO Web site.

- *Government Auditing Standards: Amendment No. 1, Documentation Requirements When Assessing Control Risk at Maximum for Controls Significantly Dependent Upon Computerized Information Systems*—This amendment establishes a field work standard requiring documentation in the planning of financial statement audits in certain circumstances. (GPO Stock No. 020-000-00275-1)
- *Government Auditing Standards: Amendment No. 2, Auditor Communication*—This amendment requires specific communication concerning the auditor's work on compliance with laws and regulations and internal control over financial reporting. It also requires the auditor to emphasize in the auditor's report on the financial statements the importance of the reports on compliance with laws and regulations and internal control over financial reporting when these reports are issued separately from the report on the financial statements. (GPO Stock No. 020-000-00274-3)
- *Government Auditing Standards: Amendment No. 3, Independence*—This amendment establishes independence standards for CPAs, non-CPAs, government auditors, and performance auditors. It deals with a range of auditor independence issues, including restrictions on nonaudit services.
- *Interpretation of Continuing Education and Training Requirements*—*Government Auditing Standards* establishes specific CPE requirements for auditors working on audits performed in accordance with those standards. This interpretation guides audit organizations and individual auditors on implementing the CPE requirements by answering the most frequently asked questions from the audit community.

Office of Management and Budget

Circulars

The OMB issues cost and grants management circulars to establish uniform policies and rules to be observed by federal agencies for the administration of federal grants. Federal agencies then adopt these circulars in their regulations. The process for issuing circulars includes due process, with a notice of any proposed changes in the *Federal Register*, a comment period, and careful consideration of all responses before issuance of final circulars. The following table includes a list of circulars relevant to audits of state and local governments. Copies of these circulars are available under the grants management heading on the OMB Web site at www.omb.gov.

OMB Circulars Relevant to Audits of State and Local Governments

<i>Circular Number</i>	<i>Title</i>	<i>Issue Date</i>
A-21 (Revised)	<i>Cost Principles for Educational Institutions</i>	August 2000
A-87 (Revised)	<i>Cost Principles for State, Local, and Indian Tribal Governments</i>	August 1997
A-102 (Revised)	<i>Grants and Cooperative Agreements With State and Local Governments</i>	August 1997
A-110 (Revised)	<i>Uniform Administrative Requirements for Grants and Agreements With Institutions of Higher Education, Hospitals, and Other Nonprofit Organizations</i>	September 1999
A-133 (Revised)	<i>Audits of States, Local Governments, and Nonprofit Organizations</i>	June 1997

OMB Circular A-133 Compliance Supplement

The Supplement (Appendix B in OMB Circular A-133) sets forth the major federal compliance requirements to consider in a Circular A-133 audit of states, local governments, and nonprofit organizations that receive federal assistance. You can find the 2002 Supplement (and the preceding 2001 Supplement) on the OMB's Web site at the grants management address, www.omb.gov/grants. You may purchase a printed copy (product no. 041-001-00580-3) or CD ROM version (product no. 041-001-00581-1) of the 2002 Supplement from the Government Printing Office at (202) 512-1800.

Other Guidance

Standard forms prescribed by OMB's grants management circulars can be obtained on the grants management section of OMB's Web site (see above). The data collection form (Form SF-SAC) which is required to be completed for all Circular A-133 audits, can be completed online at the Federal Audit Clearinghouse Web site at harvester.census.gov/sac. That site also has PDF versions of the data collection form.

The Catalog of Federal Domestic Assistance (CFDA) is a government-wide compendium of federal programs, projects, services, and activities that provide assistance or benefits to the public. Program information provided by the CFDA includes authorizing legislation and audit requirements. The General Services Administration (GSA) is responsible for the dissemination of federal domestic assistance information through the catalog and maintains the information database from which program information is obtained. A searchable version of the CFDA is located at www.cfda.gov.

The GSA also makes copies of the CFDA available to certain specified national, state, and local government offices. You can locate those depositories through the GSA Web site at www.gsa.gov. The CFDA also may be purchased from the GPO by calling (202) 512-1800 or through the online bookstore at www.gpo.gov.

PCIE Audit Committee Guidance

The President's Council on Integrity and Efficiency (PCIE) Audit Committee publishes supplemental, nonauthoritative guidance for federal officials addressing issues arising from the implementation of the Single Audit Act and related OMB Circulars.

Over the years, the PCIE Audit Committee (or its predecessors) has issued a total of six position statements. Most of these position statements were developed to address issues related to audits conducted under the Single Audit Act of 1984, Circular A-128, and the March 1990 version of Circular A-133. Only PCIE Statement No. 4, which establishes uniform procedures for referrals of substandard audits to state boards of accountancy and the AICPA, continues to be applicable to audits conducted under the

Single Audit Act Amendments of 1996 and the June 1997 Circular A-133. You can find PCIE Statement No. 4 on IGnet, the Inspectors General Web site, in the Single Audit Library. The Internet address for that library is www.ignet.gov/pande/audit/mains.html.

Note that the PCIE Audit Committee also is responsible for developing nonfederal audit review guidelines in the form of a desk review guide and a quality control review guide. Those guides, which have been updated for the Single Audit Act Amendments of 1996 and the June 1997 revision to Circular A-133, are available at the Internet address in the paragraph above.

Government Finance Officers Association

The Government Finance Officers Association (GFOA) can be contacted at 203 North LaSalle Street, Suite 2700, Chicago, IL 60601-1210; phone (312) 977-9700; fax (312) 977-4806; www.gfoa.org. Its publications include:

- *Governmental Accounting, Auditing and Financial Reporting: Using the GASB 34 Model*—This publication, commonly known as the GAAFR or “Blue Book,” provides detailed professional guidance on the practical application of the new financial reporting model to state and local governments. The basic text of the GAAFR also is available on CD-ROM. (*The GAAFR Study Guide Outlines and Exercises* and *The GAAFR Self-Study Course* also are available to assist those wishing to use the GAAFR for instructional or self-study purposes.)
- *An Elected Official’s Guide to the New Governmental Financial Reporting Model*—This booklet provides a comprehensive overview of the new governmental financial reporting model established by GASB Statement No. 34.
- “General-Purpose Government Checklist for the Certificate of Achievement for Excellence in Financial Reporting Program”—This detailed checklist has been completely revised to reflect GASB Statement No. 34 and is available free of charge on the GFOA Web site.

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- *An Elected Official's Guide to Fund Balance*—This booklet provides the non-accountant with a concise explanation of the meaning of the various components of fund balance and focuses on how to properly interpret the meaning of fund balance in the general fund.
 - *An Elected Official's Guide to Auditing*—This booklet provides elected officials, management, and other nonaudit professionals with practical information concerning the audit process for state and local governments, including discussion of annual audits of financial statements; Yellow Book audits; Circular A-133 audits; auditor's reports; managing the financial audit; performance auditing; and internal auditing. (Recently updated.)
 - *Model Request for Proposal for Auditing Services (diskette)*—This diskette includes a model request for proposals for auditing services in WordPerfect 6.1 format. (Recently updated.)
 - *Evaluating Internal Controls: A Local Government Manager's Guide*—This publication is designed for public managers seeking the practical guidance needed to assume a leadership role in the design, implementation, and maintenance of a comprehensive framework of internal control.
 - *An Elected Official's Guide to Internal Controls and Fraud Prevention*—This booklet provides a concise yet comprehensive overview of internal controls and fraud prevention in the public sector. Explanations cover a wide range of topics, including the control environment; accounting systems; control policies and procedures; evaluating internal controls; the causes, cost, and prevention of fraud; common types of fraud; and how management can detect fraud.
 - *Accounting Issues and Practices: A Guide for Smaller Governments*—This 12-chapter manual provides “how to” advice on the basic duties of local government finance officials. Sample documents are included throughout.

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- *A Guide to Arbitrage Requirements for Governmental Bond Issues and 1994 Supplement*—These two publications present a comprehensive overview of federal arbitrage requirements.
 - *Pension Accounting and Reporting; Pension CAFRS: Guidelines for the Preparation of a Public Employee Retirement System Comprehensive Annual Financial Report; 2000 Survey of State and Local Government Employee Retirement Systems—Survey Report*; and the *PENDAT 2000 Database and User's Manual*—Various publications and other products on the administration of and financial reporting for PERs.
 - *GAAFR Review*—This 8-page subscription newsletter, issued 10 times each year, covers major issues in governmental accounting, auditing, and financial reporting and includes analyses of recent authoritative pronouncements.
 - *Recommended Practices for State and Local Governments*—GFOA's recommended practices identify "best practices" in each of the major disciplines of state and local government finance. They are available free of charge on the GFOA Web site.
 - *Financial Indicators Data Base*—GFOA makes available each year key data extracted from CAFRs submitted to its certificate program. Separate data bases are available for counties, general-purpose governments, and school districts.

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This Audit Risk Alert replaces *State and Local Governmental Developments—2001*.

The State and Local Governmental Developments Audit Risk Alert is published annually. As you encounter audit and industry issues that you believe warrant discussion in next year's Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert would also be greatly appreciated. You may e-mail these comments to lgivarz@aicpa.org or write to:

Leslye Givarz
AICPA
Harborside Financial Center
201 Plaza Three
Jersey City, NJ 07311-3881

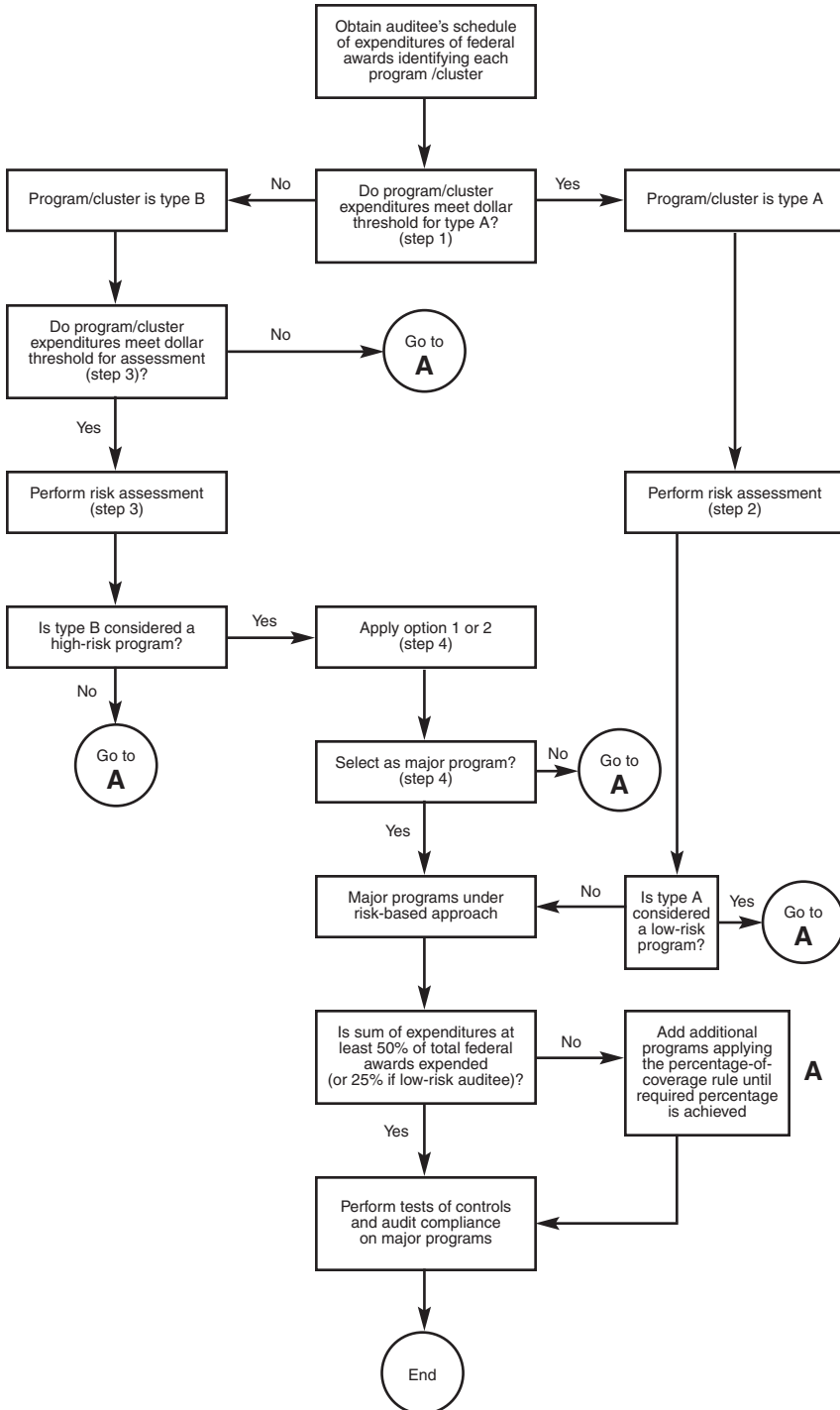
We also suggest that you review the annual AICPA *Audit Risk Alert*, which is a general update on economic, auditing, accounting, and other professional developments. That publication discusses numerous general audit topics of interest that, although not specifically geared toward an audit of the financial statements of state and local governments, might be relevant to auditors of those financial statements.

Circular A-133 Audit Refresher—Major Programs

As discussed elsewhere in this Alert, various organizations that monitor the quality of governmental audits are identifying problem areas that include the requirements for applying a risk-based approach to determining major programs in Office of Management and Budget's (OMB's) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those requirements are designed to focus the Circular A-133 audit on higher-risk programs. To complement that discussion, we present this refresher on Circular A-133's requirements for major program selection. Auditors should also refer to Circular A-133 and chapter 7 of Statement of Position (SOP) 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, for the underlying requirements.

Determining major programs using the risk-based approach is a four-step process that involves the auditor (1) determining type A and type B programs, (2) identifying low-risk type A programs, (3) identifying high-risk type B programs, and (4) selecting major programs. The following flowchart, reprinted from Exhibit 7.1 of SOP 98-3, illustrates this process.

Only in situations of a "first year" audit can the auditor deviate from using the risk-based approach. Section 520(i) of Circular A-133 defines a first-year audit as the first year an entity is audited under the June 30, 1997, revision to Circular A-133 or as the first year of a change in auditors. That exception allows the auditor to elect to determine major programs as all type A programs plus any type B programs as are necessary to meet the percentage-of-coverage rule described in step 4. However, to ensure that a frequent change of auditors will not preclude the audit of high-risk type B programs, the election for first-year audits may not be used more than once every three years.



Step 1—Determining Type A and Type B Programs

To select major programs, the auditor must first identify federal programs as being either type A or type B as defined in Circular A-133, section 520(b). In general, type A programs are larger federal programs, and type B programs are smaller federal programs. For purposes of determining major programs, a cluster of programs¹ is considered one program. For example, if the auditee expends federal awards under more than one program in the child nutrition cluster (which is made up of the school breakfast program, the national school lunch program, the special milk program for children, and the summer food service program for children), those programs should be considered together as one program.

Type A programs depend on an auditee’s total federal awards expended, as shown in the following table. Federal programs that do not meet the type A criteria are type B programs:

<i>When Total Federal Cash and Noncash Awards Expended Are—</i>	<i>Type A Programs Are Any Programs With Federal Awards Expended That Exceed the Larger of—</i>
More than or equal to \$300,000 and less than or equal to \$100 million	300,000 or 3% (0.03) of federal awards expended
More than \$100 million and less than or equal to \$10 billion	\$3 million or 0.3% (0.003) of federal awards expended
More than \$10 billion	\$30 million or 0.15% (0.0015) of federal awards expended

If an auditee’s federal awards expended include loans and loan guarantees,² the auditor may need to adjust how to apply the above criteria. Circular A-133 states that, when identifying type A programs, the inclusion of large loans and loan guarantees should not result in the exclusion of other federal programs as

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1. A cluster of programs is defined as a grouping of closely related programs that share common compliance requirements. The types of clusters of programs are research and development, student financial aid, and other clusters. “Other clusters” are defined in the Office of Management and Budget (OMB) Circular A-133 *Compliance Supplement* or are designated by a state for federal awards that the state provides to its subrecipients that meet the definition of a cluster of programs.

2. As provided in Circular A-133, sections 105 and 215(b) through (d), loans and loan guarantees represent federal awards.

type A programs. This requirement relates only to loans and loan guarantees and not to any other noncash awards. When, based on the auditor's professional judgment, federal programs providing loans or loan guarantees significantly affect the number or size of type A programs, the auditor should consider the loan or loan guarantee programs type A programs and exclude their value in determining other type A programs. An example of this concept is shown in paragraphs 7.8 and 7.9 of SOP 98-3.

Federal awards expended for purposes of determining type A and type B programs is the amount of cash and noncash awards, after all audit adjustments are made, shown on the face of the current-year schedule of expenditures of federal awards, including the notes thereto, and in the data collection form. An auditor who uses the prior-year schedule or preliminary current-year estimates to plan the audit should recalculate the threshold for type A programs based on the final amounts to ensure that federal awards are properly classified as type A or B. Although the calculation of the threshold (and the percentage-of-coverage requirement discussed in step 4) seems straightforward, some auditors are not complying with the requirement. Rounding the calculation is not allowed; if the type A threshold calculates to \$4,893,000, the auditor cannot round the number to \$4.9 million.

Step 2—Identifying Low-Risk Type A Programs

After completing step 1, the auditor should perform a risk assessment of each type A program to identify those that are low-risk as provided in section 520(c) of Circular A-133. For a type A program to be considered low-risk, *both* of the following conditions *must* be met: (1) the program has been audited as a major program in at least one of the two most recent audit periods (in the most recent audit period in the case of a biennial audit), and (2) in the most recent audit period, the program had no audit findings that represent reportable conditions in the internal control over major programs or material noncompliance with the provisions of laws, regulations, contracts, or grant agreements that are related to a major program. There is no auditor judgment involved in meeting

either of these criteria. The fact that a type A program was not type A in the previous two years is not relevant. If a type A program was not audited in the two most recent audit periods, without regard to whether it was type A or type B during those periods, it cannot be considered low risk and, therefore, must be audited in the current period. Similarly, if an auditee did not previously participate in a federal award program that is a type A program in the current year, that program was not audited in the two most recent audit periods and cannot be considered low risk.

Except in the situations discussed in the previous paragraph, Circular A-133 permits the auditor to conclude, based on professional judgment, that a type A program is low-risk even though (1) in the prior audit period it may have had known or likely questioned costs greater than \$10,000 for a type of compliance requirement, (2) known fraud has been identified, or (3) the summary schedule of prior audit findings materially misrepresents the status of a prior audit finding. SOP 98-3 gives the following example in which the auditor, based on professional judgment, could decide that the program is low-risk in the current year: Funds expended under a federal program in the prior year totaled \$10 million, there were known questioned costs of \$11,000 that related to one isolated instance, and there were no additional likely questioned costs.

In making the final determination of whether a type A program is low-risk, the auditor also should consider the following risk criteria:

- The nature of oversight exercised by federal agencies and pass-through entities
- The inherent risk of the program
- The results of audit follow-up
- Whether any changes in the personnel or systems affecting a type A program have significantly increased its risk
- The identification by the federal agency, as provided by the OMB in the *Compliance Supplement*, that a program is higher risk

Step 3—Identifying High-Risk Type B Programs

After completing steps 1 and 2, the auditor should identify type B programs that are high-risk. Step 3 is discussed in section 520(d) of Circular A-133. Before risk assessing type B programs, the auditor should consider whether:

- There are low-risk type A programs. When there are no low-risk type A programs (either because there are no type A programs or because none of the type A programs are low-risk), the auditor is not required to perform step 3. When there are no type A programs, the auditor would audit as major enough programs to meet the percentage-of-coverage rule, as discussed below in step 4. When none of the type A programs are low-risk, the auditor would audit as major all type A programs plus any additional type B programs needed to meet the percentage-of-coverage rule.
- Option 1 or option 2 will be used in step 4 as discussed below. The auditor's decision of which option to choose will likely be based on audit efficiency and will affect how many type B programs are subject to risk assessment. Under option 1, the auditor is required to perform a risk assessment on all type B programs (except small type B programs as discussed below). In comparison with option 2, option 1 will likely require the auditor to perform more type B program risk assessments, but may also result in the auditor having to audit fewer major programs. Under option 2, the auditor is only required to identify high-risk type B programs up to the number of low-risk type A programs. In comparison with option 1, option 2 will likely require the auditor to perform fewer type B risk assessments, but may also result in the auditor having to audit more major programs. Paragraph 7.15 of SOP 98-3 provides examples of these concepts. Under either option, any programs that a federal agency or pass-through entity requests be audited as discussed in step 4 below must be audited as a major program.

An auditor is not expected to perform risk assessments on relatively small federal programs. Circular A-133 only requires the auditor to

perform risk assessments on type B programs as shown in the following table.

<i>When Total Federal Cash and Noncash Awards Expended Are—</i>	<i>Perform Risk Assessment for Type B Programs That Exceed the Larger of—</i>
More than or equal to \$300,000 and less than or equal to \$100 million	\$100,000 or 3% (0.03) of federal awards expended
More than \$100 million	\$300,000 or 0.3% (0.003) of federal awards expended

The auditor should identify type B programs that are high-risk using professional judgment, the risk criteria bulleted above in step 2 for type A programs, and the following additional risk criteria for type B programs.

- Weaknesses in the internal control over compliance for the program
- Whether the program is administered under multiple internal control structures
- A weak system for monitoring subrecipients when significant parts of the program are passed through to subrecipients
- The extent to which computer processing is used
- Prior audit findings that have a significant impact on a program or for which no corrective action has been implemented since the findings were identified
- The program has not recently been audited as major

Except for known reportable conditions in internal control or instances of noncompliance, a single risk criteria would, in general, seldom cause a type B program to be considered high-risk.

Step 4—Selecting Major Programs

After completing steps 1 through 3, the auditor identifies major programs. At a minimum, sections 215(c) and 520(e) of Circular A-133 require the auditor to audit all of the following as major programs:

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- All type A programs, except those identified as low-risk under step 2
 - High-risk type B programs as identified under either of the two options described below
 - Programs to be audited as major based on a federal agency request, in lieu of the federal agency conducting or arranging for additional audits as discussed below
 - Additional programs, if any, that are necessary to meet the percentage-of-coverage rule described below

Section 520(e)(2) of Circular A-133 provides two options for identifying high-risk type B programs.

- Under option 1, the auditor is expected to perform risk assessments of all type B programs that exceed the amount specified in the table shown in step 3, and to audit at least one-half of the high-risk type B programs as major, unless that number exceeds the number of low-risk type A programs identified in step 2 (that is, the cap). In this case, the auditor would be required to audit as major the same number of high-risk type B programs as the cap.
- Under option 2, the auditor is only required to audit as major one high-risk type B program for each type A program identified as low-risk in step 2. Under this option the auditor would not be required to perform risk assessments for any type B program when there are no low-risk type A programs (that is, the cap is zero).

Paragraph 7.18 of SOP 98-3 provides an example of the application of these options. The auditor may choose option 1 or option 2. There is no requirement to justify the reasons for selecting either option. The results under options 1 and 2 may vary significantly, depending on the number of low-risk type A programs and high-risk type B programs. Circular A-133 encourages the auditor to use an approach that provides an opportunity for different high-risk type B programs to be audited as major over a period of time.

Section 215(c) of Circular A-133 provides for a federal agency to request an auditee to have a particular federal program audited as a major program in lieu of the federal agency conducting or arranging for additional audits. To allow for planning, such requests are required to be made at least 180 days before the end of the fiscal year to be audited. The auditee, after consultation with its auditor, should promptly respond to such a request by informing the federal agency whether the program would otherwise be audited as a major program using the risk-based approach and, if it would not, the estimated incremental cost to audit the program as a major program. The federal agency must then promptly confirm to the auditee whether it wants the program audited as a major program. If the program is to be audited as a major program based on the federal agency's request, and the federal agency has agreed to pay the full incremental costs, then the auditee must have the program audited as a major program. This approach also may be used by pass-through entities for a subrecipient.

Circular A-133 requires the auditor to audit, as major programs, federal programs with federal awards expended that, in the aggregate, encompass at least 50 percent of the total federal awards expended unless the auditee meets the criteria for a low-risk auditee, as discussed below. If the auditee is a low-risk auditee, the auditor is only required to audit as major programs federal programs with federal awards expended that, in the aggregate, encompass at least 25 percent of the total federal awards expended. (Again, rounding the calculation is not allowed.) If the total major programs selected do not equal 50 percent (or 25 percent in the case of a low-risk auditee) of the total federal awards expended, the auditor should select additional programs (either type A or type B) to equal the applicable percentage and test them as major programs. The auditor may select additional programs to meet the percentage-of-coverage rule based on professional judgment and without regard to risk assessment. The auditor should apply the percentage-of-coverage rule after all other steps in the risk-based approach are completed. The auditor cannot just select programs making up 50 percent of federal awards expended without completing the other steps.

Section 530 of Circular A-133 establishes certain conditions for determining whether an auditee is low-risk. An auditee that meets all of the following conditions for each of the preceding two years (or in the case of biennial audits, the preceding two audit periods) qualifies as a low-risk auditee and is eligible for 25 percentage of coverage as discussed above:

- Single audits were performed on an annual basis in accordance with Circular A-133. An auditee that has biennial audits does not qualify as a low-risk auditee, unless agreed to in advance by the cognizant or oversight agency for audit.
- The auditor's opinions on the financial statements and the schedule of expenditures of federal awards were unqualified. However, the cognizant or oversight agency for audit may judge that an opinion qualification does not affect the management of federal awards and may provide a waiver.
- There were no deficiencies in internal control over financial reporting that were identified as material weaknesses under the requirements of *Government Auditing Standards*. However, the cognizant or oversight agency for audit may judge that any identified material weaknesses do not affect the management of federal awards and may provide a waiver.
- None of the federal programs classified as type A programs in either of the preceding two years (or in the case of biennial audits, the preceding two audit periods) had audit findings of any of the following: (1) material weaknesses in the internal control over compliance, (2) noncompliance with the provisions of laws, regulations, contracts, or grant agreements that have a material effect on the type A program, and (3) known or likely questioned costs that exceed 5 percent of the total federal awards expended for a type A program during the year.

Section 520(g) of Circular A-133 requires that there be audit documentation of the risk assessment process used in determining major programs. It is therefore necessary for the auditor to document adequately, as required by generally accepted auditing standards (GAAS) and *Government Auditing Standards*, the determination of major programs.

Schedule of Findings and Questioned Costs and Data Collection Form

Information needed to determine major programs is required to be reported on the schedule of findings and questioned costs and the data collection form. For example, the schedule and form require the auditor to report the dollar threshold to distinguish type A and type B programs and whether the auditee qualifies as low risk. The auditor should review the information on the schedule and form to ensure that it is consistent with the information developed during the audit and consistent between the schedule and the form.

Help Desk—The AICPA Practice Aid *Auditing Recipients of Federal Awards: Practical Guide for Applying OMB Circular A-133*, Audit of States, Local Governments, and Non-Profit Organizations, *Second Edition*, includes practical checklists for performing risk assessments and selecting major programs.

The Internet—An Auditor's Research Tool

If used properly, the Internet can be a valuable tool for auditors. Through the Internet, auditors can access a wide variety of global business information. For example, information is available relating to professional news, state CPA society information, IRS activities, software downloads, university research materials, currency exchange rates, stock prices, annual reports, and legislative and regulatory initiatives. Not only are such materials accessible from the computer, but they are also available at any time, often free of charge.

A number of resources provide direct information, whereas others may simply point to information inside and outside of the Internet. Auditors can use the Internet to:

- Obtain audit and accounting research information
- Obtain information, regulations, and documents from federal agencies and departments
- Discuss audit issues with peers
- Communicate with audit clients
- Obtain information from a client's Web site
- Obtain information from professional associations

There are caveats to keep in mind when using the Internet. Reliability varies considerably. Some information on the Internet has not been reviewed or checked for accuracy; we advise caution when you access data from unknown or questionable sources. Although a vast amount of information is available on the Internet, much of it may be of little or no value to auditors. Accordingly, auditors should learn how to use search engines effectively and efficiently. The Internet is best used in tandem with other research tools, because it is unlikely that all desired research can be conducted solely from Internet sources.

The following listing summarizes the various Web sites of many of the organizations referred to in this Audit Risk Alert, as well as others that auditors of state and local governments may find useful.

<i>Organization</i>	<i>Web Site Address</i>
American Institute of CPAs:	
Main page	www.aicpa.org
Circular A-133 audit page	www.aicpa.org/belt/a133main.htm
Association of Government Accountants	www.agacgfm.org
Department of Education Office of Inspector General	www.ed.gov/offices/OIG
Department of Housing and Urban Development:	
Office of Inspector General	www.hud.gov/oig
Real Estate Assessment Center	www.hud.gov/offices/reac
Federal Audit Clearinghouse	harvester.census.gov/sac
Federal Aviation Administration, Office of Airports, Passenger Facility Charge Branch	www.faa.gov/arp/530home.htm
Federal Chief Financial Officers Council	www.fcfof.gov
Financial Accounting Standards Board	www.fasb.org
FirstGov (the federal government's central online location)	www.firstgov.gov
General Accounting Office:	
Main page	www.gao.gov
Government Auditing Standards section	www.gao.gov/govaud/ybk01.htm
General Printing Office Access (with links to search Code of Federal Regulations, Federal Register, and Public Laws)	www.access.gpo.gov/su_docs/ index.html
General Services Administration	www.gsa.gov
Government Finance Officers Association	www.gfoa.org
Governmental Accounting Standards Board:	
Main page	www.gasb.org
Performance Measurement for Government	www.seagov.org
U.S. House of Representatives	www.house.gov
IGnet (the federal Inspectors General site):	
Main page	www.ignet.gov
Single audit library	www.ignet.gov/pande/audit/ mains.html
Internal Revenue Service	www.irs.gov
Library of Congress	lcweb.loc.gov

(continued)

*Organization**Web Site Address*

Municipal Securities Rulemaking Board	www.msrb.org
National Association of State Auditors, Comptrollers, and Treasurers	www.nasact.org
Office of Management and Budget:	
Main page	www.omb.gov
Grants management section	www.omb.gov/grants
Securities and Exchange Commission	www.sec.gov
U.S. Senate	www.senate.gov
Thomas Legislative Search	thomas.loc.gov
